

What Trickled Down? Federalism, State Government Fiscal Stress, and Local Government Outcomes

Dave Swenson
&
Liesl Eathington*
Department of Economics
Iowa State University

Introduction

Much has been written about a shift in federal to state relationships during the 1990s. Couched in terms of a renewed fiscal federalism, devolution, or even the heady rhetoric of “reinventing” government both resources and public service authority flowed to the state governments. As an example, using a mixture of carrots and sticks, the federal government instituted welfare reforms in the late 1990s intended to move more welfare recipients into the workforce by limiting eligibility terms and mandating training and workforce participation.

Somewhat less was said at the time regarding state governments’ relationships with local governments or the extent of federal re-distributions of resources beyond state governments to local governments. In short, the discussion about federalism tended to center on national and state relationships, with only incidental concern over the changes these relationships might have on local governments.¹

From the mid 1990s on, most states have been concerned with managing their historic and emerging commitments to their dependent populations, maintaining their overall business competitiveness by paring their tax structures, balancing their desire to attract businesses with their desire to invest in educational systems at all levels, and maintaining safer communities leading to the widespread adoption of mandatory minimum sentencing and increases in the number of prisons.

Some of these issues cross jurisdictions: income and health care maintenance responsibilities for the disabled and income eligible fall jointly with the federal and state governments, and to a lesser extent to local governments. Issues over economic development and the maintenance of essential services are both state and local issues. Maintaining education quality is also a joint

* David Swenson is a scientist and lecturer, Department of Economics and in Community and Regional Planning, Iowa State University, and in the Graduation Program in Community and Regional Planning, The University of Iowa. Liesl Eathington is a scientist in the Department of Economics, Iowa State University.

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¹ There were articles addressing federal to state and to local issues, to include Watson and Gold (1997); Kettl (2000); and Honadle (2001).

undertaking of state and local government, with state governments increasingly responsible for equalizing access to educational resources and with establishing statewide standards of performance. Of late the federal government has weighed-in in this area with the No Child Left Behind provisions, although the current fiscal value of this requirement to the states and local governments is somewhat vague. And the public safety and prison provisions fall mainly on the states, although burgeoning prison populations have stressed community corrections systems.

Authority, accountability, and the allocation of resources among the many governments are the main parts of fiscal federalism. Historically, the federal government led this evolution of governing systems by either directly providing or funding federal mandates at the state and local levels. State governments, too, mostly in education and in the administration of justice, have taken the lead in assuring that certain essential services are distributed equitably and effectively throughout their jurisdictions. Over time, as cities and counties across the U.S. matured, there were increments to home rule authority that helped to transform local government activities and redefine their relationships with the states and, sometimes, the federal government.

This paper is an investigation of some of the federalism transformations that occurred in the past decade or so. In particular, it assesses the flow of resources and spending at all levels of government and sorts out which show changes in relationships. It has four sections. First is a general overview of fiscal federalism in the U.S. The second looks at the flow of federal funds into state and local governments over the past decade, primarily, and the sources and consequences of fiscal stress realized by state governments during the early 2000s. The third section looks at whether federal to state and state to local transfers changed markedly over the 1990s and how those changes might be attributed. A spatial dimension is explored to see which states were accumulating gains or losses during this period. Sets of state and local government shifts in capacity are measured with regard to governmental receipts, and whether there were major regional patterns in governmental ability to provide goods and services to citizens. Last we look at the state fiscal shock of 2000 through 2002 to see whether there were interruptions in the flow of federal to state and state to local funds.

We look at two recent periods for most of the state and local government analysis: 1992 to 2000 (the Clinton Administration), where much of the recent federalism talk and activity was centered. This was also a period of sustained economic expansion. The next time is 2000 to 2002. The year 2000 was a historical peak in real state governmental receipts, and 2002 was a year that, for many states, tax cuts, depletions of rainy day funds, and a general economic slowdown conspired to reduce state government own-source revenues sharply.

There are two important patterns of governmental activity that we are especially interested in tracking: federal and states are increasingly liable for public health costs, primarily because of expansions in the Medicaid-eligible populations coupled with faster-than-inflation rises in health costs. At a different level, states and local governments have strongly emphasized education spending, driven by concerns of interstate competitiveness, beginning way back in the Reagan Administration, and of late, associated with the federal “No Child Left Behind” initiative to stimulate better public school outcomes. We begin with an overview of federalism.

An Overview of Federalism

During the Clinton Administration, in particular the 104th Congress, there was renewed discussion and debate on federalism and the functional and fiscal relationship among the federal and the state governments.² This increased attention coincided at a time when federal program responsibility was said to be devolving and, accordingly, delegated to the states and, further, in some instances, to local governments. The most emblematic federal program change and program and policy devolution involved the 1996 Personal Responsibility and Work Opportunity Reconciliation Act. It fostered broad changes in both the structure of funding for and the performance expectations of welfare recipients – mostly low income single women with dependent children. States were rewarded financially for applying innovative and effective strategies for moving welfare mothers into the workforce. As in times before, the federal government was going to shift from strings-attached categorical funding to discretionarily vague block grant funding. According to Inman and Ruben (1997), we perhaps were witnessing a “quite revolution (p. 55).” Richard Musgrave (1997) was dubious, and observed that it historically was the case and would likely happen that the block grants would be insufficient to cover the cost of the transferred authority at the state level.

Federalism, as a social or political factor that matters practically and substantively, ebbs and flows over time. The extension of federal authority, resources, and action to sub-national governments and issues, primarily, is determined by several factors that may or may not work in concert with one another. Some of these are

- Political or policy imperatives: every president has a different perspective on the appropriate role and scope of federal activity in support of state or local governments. Large ideological differences are evident between, for example, the administrations of Johnson and Reagan, leading to different relationships and expectations among the federal and sub-national governments.
- Constitutional provisions: the 10th amendment of the U.S. Constitution reserves certain areas of state authority, irrespective of federal intentions to the contrary.
- Broad social changes: general, incremental transformations in science, society, and culture alter governmental authority and citizen expectations from governments.
- Economic issues: economic scarcity or largess affects government capacity and authority – large portions of modern government were originally launched as responses to broad national and global economic failures during the Great Depression of the 1930s.
- Prerequisites of distributive justice: affirmative action, equal opportunity, environmental remediation, regulations to internalize harmful production outcomes, and efforts to mitigate resource mal-distributions among individuals and regions all fit into this category.
- Big events: September 11, 2001, for one, and hurricane Katrina, for another, are emblematic of the need for flexible federal responses in the face of natural, economics, or political disasters to directly assist or leverage state or local government and quasi-governmental capacities.

² A very thorough and lively discussion can be found in: Inman and Rubinfeld,; Musgrave; Donahue; Qian and Weingast; among others, *Journal of Economic Perspectives* (11:4), 1997.

Historically, depression era New Deal programs greatly expanded the influence of the federal government in the economy and in society. These initiatives resulted in funding flows, via a host of agencies and programs, to individuals, states, and quasi-governmental entities chartered to promote social or economic well-being (like the Tennessee Valley Authority).

Intergovernmental fiscal relationships were much further extended during the early years of Great Society social welfare programming at the federal government level. New programs resulted in the flow of funds to states and communities as grants and as entitlement payments (either as cash or commodities) to individuals. President Johnson's Model Cities programs extended federal resources to cities, quasi-community, and neighborhood entities. This period of expanding fiscal federalism, sometimes criticized as "creeping federalism"³ continued through the Nixon Administration. A wide array new programs, grants, and transfers were enacted for employment and training, general revenue sharing, regional planning and programming, funding for new environmental laws, food and nutrition assistance to the poor, and city and state infrastructure and human services block grants. During the Ford and Carter Administrations, most of the basics of fiscal federalism remained. Carter's administration tried to focus aid, as in the Urban Development Action Grants for housing assistance, and developed counter-cyclical jobs programs in coordination with the states.

This period of active federal involvement was confronted head-on by the Reagan Administration. From the beginning, it articulated an idea of "New Federalism" that was going to redefine the multitude of federally-administered categorical programs into a subset of super-grants or block grants. The tradeoff for what everyone soon realized was to be an overall net reduction in federal funds was fewer federal strings attached and a promise of greater state level autonomy and authority for programming.⁴ Important categories of federal funding for housing, general revenue sharing, and categorical health and income maintenance relief were either eliminated or repackaged with large block grants for urban development, social services, health care, workforce security, and environmental regulation and remediation.

We can chart the federal fund flows to state and local governments over the years. Figure 1 identifies federal grants-in-aid as fractions of state and local government receipts over a 35 year span. A general upward trend is apparent through 1978 when federal funds accounted for almost 23 percent of all state and local government revenues. We see, too, the sharp reduction in grants-in-aid during Reagan Administration (1981 through 1988). Federal funds as a percentage of local government revenues had declined to 14.2 percent by 1987. An apparent renaissance of fiscal federalism followed through the 1999 period where the fraction of state and local receipts from federal sources increased to 18.9 percent by the end of the Clinton years.

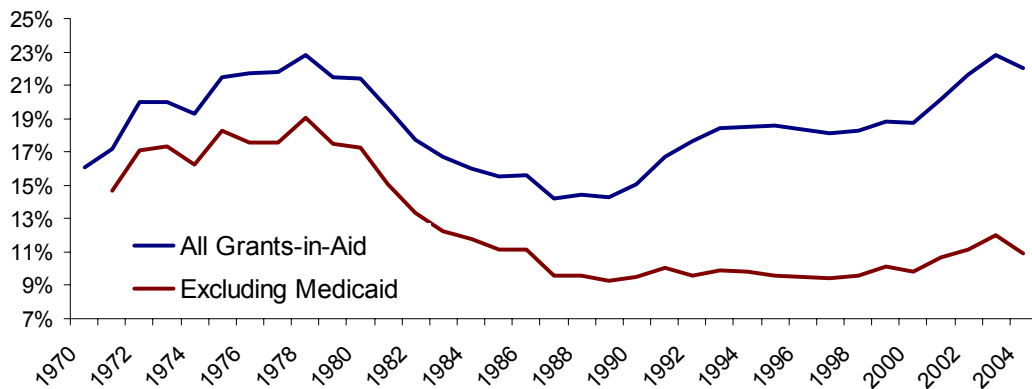
³ The term's origin is difficult to trace, but was applied occasionally to the persistent inveigling of federal power and authority into the affairs of issues thought reserved to the states. By way of measure, the sum of government and government authority in 1960 was tremendously different than that in, say, 1976, but changes from year to year were, generally, incremental.

⁴ At the time, once the accumulating value of the cuts were realized, these reforms were occasionally called "fend-for-yourself federalism."

A huge spike upward followed driven mostly by constrained own source government receipts at the state and local level because of the recession (shrinking the denominator) and by increased federal effort for the sake of homeland security following the events of September 11, 2001. Taken as a whole, federal fiscal flows into sub-national governments in 2003 appeared at or very near their historical, pre-Reagan Administration highs – that the Reagan federalism reforms were for naught.

Figure 1⁵

Total Federal Grants-in-Aid as a Percentage of State and Local Receipts



A different picture emerges when we remove Medicaid grants from the grants-in-aid amounts. Medicaid grants are health services entitlements paid to low income (traditional income-maintenance welfare) recipients and their children through programs and services administered and fund-matched by the states. Medicaid payments also support the much more expensive medical needs of the disabled and the low-income elderly (who also receive Medicare)⁶. When those payments are removed, federal fiscal federalism net of Medicaid spending did not rise meaningfully during the end of the Reagan years through the end of Clinton’s term. In 1988 federal aid excluding Medicaid amounted to 9.6 percent of state and local receipts. By the end of 2000 it was 9.8 percent. The federal percentage spiked in 2003 at 12 percent following a huge flow of homeland security funds into state and local governments.

The rhetoric of a resurgent federalism via additional block grants and state and local authority and programming has to differentiate between the Medicaid and the non-Medicaid portions of federal aid. Doing so, we indirectly validate Musgrave’s (1997) concern that a half century of “fiscal activism and federal leadership (68)” had ended. By the end of 2004, at least half of the grants to state and local governments were made up of Medicaid payments, compared to 16 percent in

⁵ All data for this research came from the Department of Commerce, Census Bureau, Governments Division historical government finance data files (both published and unpublished); the Bureau of Economics Analysis; and the Economic Report of the President (2006).

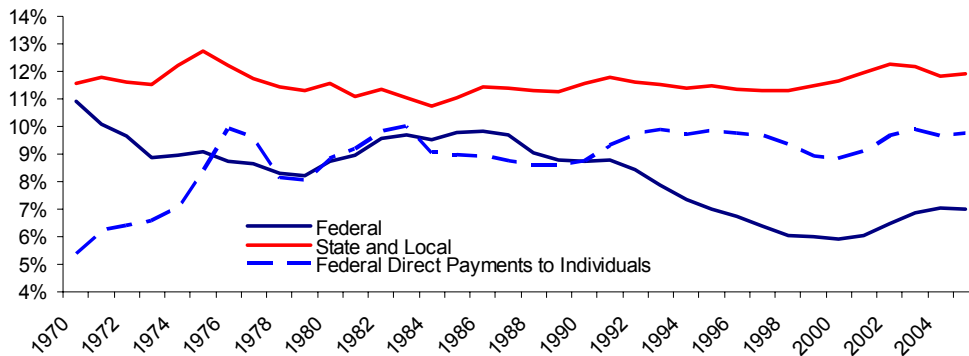
⁶ The recent drug provisions of Medicare will transfer many of the elderly Medicaid recipients to the new program.

1978. For the vast majority of state and local government programs and citizens for whom Medicaid funding is not an issue, the federal fraction of the state and local supply of available revenues is and has been fixed at about the 10 percent level since the end of the 1980s. Regarding this aspect of federal fiscal activism, in the non-entitlement area, the Reagan Administration's policies have proved incredibly durable. This durability is further demonstrated in Figure 2.

Here we show three measures of the size of government in the U.S. relative to the rest of the economy. The first two measures are of federal and of state & local government investment and consumption as fractions of Gross Domestic Product (GDP).⁷ In 1970, the federal government was 11 percent of GDP and declined relatively persistently through 1979 to 8.2 percent. During the Reagan years, especially because of a federal expansion in defense-related spending at the heights of the Cold War, the federal share of GDP grew to 9.8 percent by 1986. Thereafter, the federal share declined persistently through 2000 where it reached its recent historic low of 5.9 percent. Since, through 2005, the federal share has grown to 7 percent.

Figure 2

Federal and State & Local Government Investment and Consumption as Percentages of GDP



State & local governments' shares have not seen such dramatic swings. The high point for state and local governments was 12.7 percent of GDP in 1975, and the low was 10.7 percent in 1984. The state and local share has remained relatively flat, but rose some during the 1998 to 2002 period to 12.2 percent of GDP.

The federal shares do not include the payments to individuals that are made on their behalf. We added those values for illustrative purposes. Those payments include all payments in support of social security, income maintenance, Medicare, payments to veterans and their care, and direct

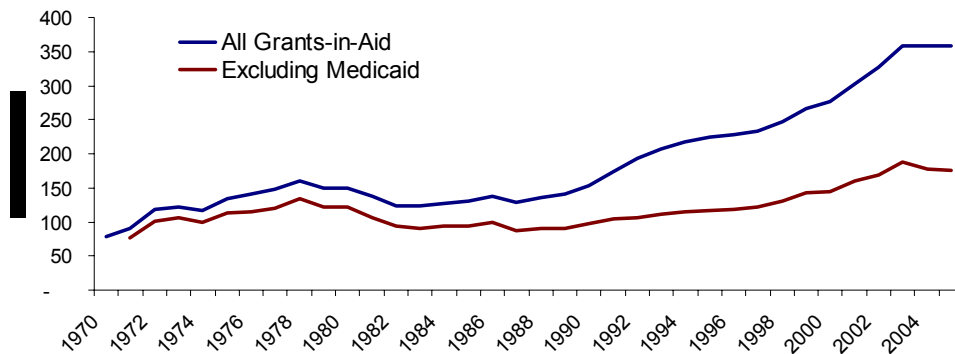
⁷ The government consumption component of GDP includes the purchase of all goods, services, and structures from businesses, employee compensation (purchases from households), the consumption of capital and the purchase of fixed assets, and deductions of government enterprises. It does not include transfer payments or purchases by government enterprises (utilities, for example), interest paid or received, and transactions in government assets.

spending on education and training. Those values grew rapidly from 5.4 percent in 1970 to about 10 percent by 1976. Since, they have never gone below 8 percent (1979) nor higher than the 10 percent threshold of 1976. A better handle on all federal obligations is gained when payments to individuals are combined with the other federal figures. When added together, the fractions of GDP from total federal spending along with payments to individuals still declined persistently during most of the 1990s, but have since risen to 16.7 percent in 2005.

Figure 3 tracks federal aid to states and local governments both with and without Medicaid. All grants-in-aid declined from 1979 through 1982, and increased thereafter. With Medicaid, real grants-in-aid grew from \$150.7 million in 1979 to \$357.8 million in 2003, over 137 percent. Excluding Medicaid, federal aid grew from 121.9 million in 1979 to 188.5 million by 2003, or 56 percent, before tailing off some.

Figure 3

Value of Federal Grants-in-Aid in Constant 2005 Amounts



A rising tide lifts all boats, we are reminded, and robust economic growth needs to be taken into account when comparing government revenue and spending activity over time. Over this period of time (1979 to 2003) total U.S. real personal income rose by 108 percent, personal income per capita rose by 60 percent, and the nation’s population rose by 29 percent. Governmental spending and personal economic statistics are combined and analyzed in the next section.

Sorting Out Recent State Government Fiscal Stress

There are several things that we know about state governments during the 1990s. First, both real tax collections per capita and real aid from the federal government increased strongly. Second, accordingly, there were real per capita increases in state direct and indirect spending during this time (see Swenson and Deller, 2001, for analysis of changes in 1992 to 1997) – state governments were expanding the scope of public goods delivered. Third, the vast majority of states reduced their personal and corporation income tax rates or they expanded exemptions to individual and corporate taxation (Johnson 2002). Fourth, by 2002 most states were complaining loudly of fiscal

stress, as a combination of tax rate cuts, tax shifts, took their tolls on state collections. Last, there is a lack of consensus as to the causes of the states' fiscal stress; if indeed cause is the right word.

Contrasting explanations for this interstate mess can be found among two prominent organizations that address economic and federalism issues. The Cato Institute, a libertarian think tank, issued a report at this time (Edwards 2003) condemning the whole of the 50 states for tax and spending excesses. In rebuttal, the Center on Budget and Policy Priorities (CBPP), a more liberal, government-service oriented think tank, argued that there were very strong structural reasons for rapid state growth during the 1990s. These were due to the baby boom echo driving educational system demands and the increase of the number of elderly and other deserving entitlement recipients created expansions in demands for welfare based state services (McNichol 2003).

Cato argued that states should have reduced spending to a "natural rate" of increase based on inflation and population growth, that the excess should have been returned sooner to citizens, and that states should consider lowering public costs by privatizing services (p14). CBPP argued further that states in an effort to maintain their tax rate competitiveness broadly lowered rates beyond what was prudent, in what is conventionally called a race to the bottom, and that also put them in a tenuous position during the economic downturn.

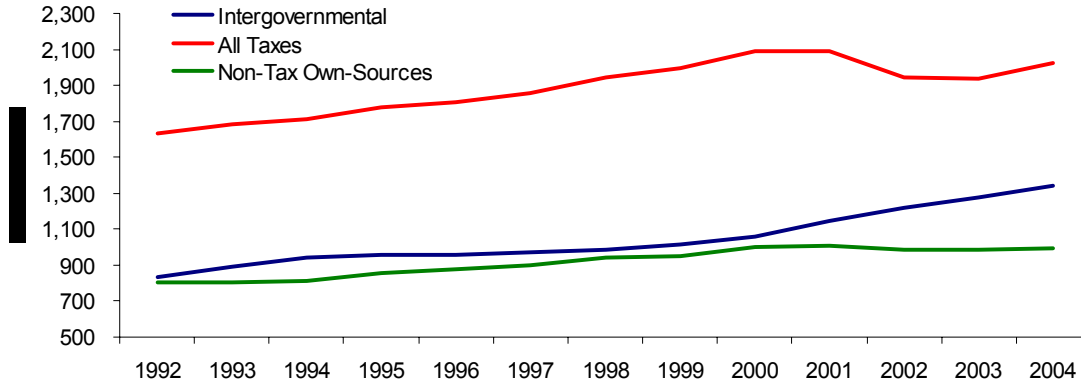
Both reports are selective in their methodologies and their facts.⁸ Still, they contain large elements of truth. First, to the growth in state taxes and other receipts, real tax collections per capita by state government rose from \$1,632 in 1992 to \$2,086 by 2000, an increase of 28 percent or a 3.1 percent compounded annual rate of change. Total aid from the federal government rose over this same period by 3 percent annually. Total state government general revenue increased by an annual real rate of 3 percent as well. Figure 4 illustrates the patterns of change over time for the states.

Real personal income per capita rose by 3 percent annually over this period. The claim that total state government general receipts drastically exceeded either inflation or population growth in and of itself may have been correct, but receipts as fractions of income remained quite constant (Figure 2 illustrates the overall stability of combined state and local activity relative to national product). Real tax receipts per person stayed flat in 2001 and then declined in 2002 by almost 7 percent before recovering in 2004 to a level still below the 2000/2001 peaks. Non-tax own-sources posted real growth per capita during the 1990s and declined, too, during the downturn. Federal funds, however, though growing relatively consistently with income growth during the 1990s grew by almost 27 percent between 2000 and 2004.

⁸ Cato mixes displays of inflation adjusted and unadjusted numbers in their presentations making it somewhat problematic to sort value from hyperbole. CBPP asserts that state spending growth was slower than income growth given the period that they measure. The claim is true, but barely; on a per capita basis the spread is much more meager than claimed in their research.

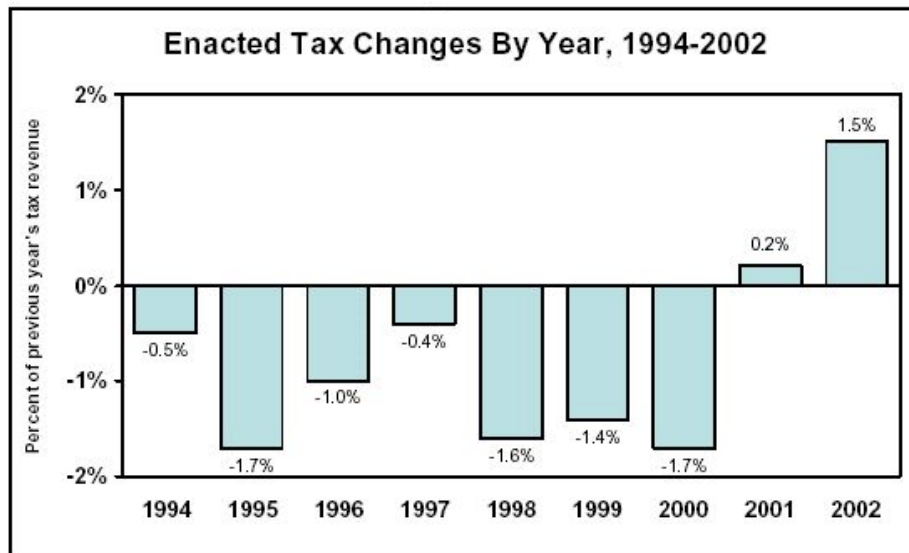
Figure 4

Real Receipts Per Capita in Selected State General Revenues



The states had strong growth in real tax collections per capita, and they began to trim tax collections. According to the CBPP, 43 states enacted tax cuts between 1994 and the end of 2000. The effects of these cuts are displayed in Figure 5. This graph illustrates the value of the cut state taxes against the previous year's collections for the whole U.S. It is evident that cuts began in earnest in the mid 1990s waned by 1997, and then they increased again before the period when the states found themselves in their 2002 through 2003 period of revenue stress. By 2002 we see the states reversing themselves and enacting tax increases.

Figure 5⁹



When comparing Figures 4 and 5 we see that even though the states were cutting tax rates, their real collections continued to rise on a persistent upward slope, nonetheless. On the face of it, the

⁹ Johnson, CBPP, 2002

tax cutting that occurred during this time appears to have made sense. Whether those cuts were or continue to be imprudent remains to be seen.

State and Local Government Revenue and Expenditure Patterns, 1992 to 2000

Did a renewed flow of federal aid to state governments stimulate state tax collections, tax reductions, or changes in state government spending? Did expansions in state government activity during the 1990s find their way into state government transfers in support of local governments – a trickling down as it were? Did renewed discussions about fiscal federalism that coincided largely with federal and state welfare reforms have corollaries at the state to local levels?¹⁰ As has been shown, questions about the overall size of federal and state & local government activity need to be tempered and placed into context – too broad of an aggregation distorts. Through the 1990s, the federal share of the economy declined (both in terms of direct spending and transfers). State & locals' shares remained relatively fixed. In recent years, owing to heightened concern over national safety, wars, and natural devastation, the federal share of the nation's economy has grown.

Table 1 lists the average annual real changes per capita in select general revenue and expenditure items. Both state and local government revenues increased in real terms – state government by \$99, and local governments by \$72 per year, per person. Real per capita income growth averaged \$760.62 per year. Looking first at the revenues, we see that 56 percent of state real growth per capita from 1992 to 2000 was due to tax increases, and 27 percent from federal funds increases.

For local governments, however, the preponderance of gain was in aid from the state. It accounted for 43 percent in their general revenue growth. The remainder was split between all taxes (27 percent) and all non-taxes (25 percent).

The expenditure side tells us the uses for which gains were put. State direct spending rose by \$55.78, and local direct spending rose by \$67.49. The largest amount of gain for state governments per capita was in welfare spending at a third of the total, followed by direct state spending for education at about a quarter of the total. Expanded spending on corrections is often considered a major portion of state government shifting obligations in the 1990s, but in this period they only accounted for 8 percent of the change.

For local governments, a majority 56 percent of direct spending gains went to education, followed by 28 percent in the inclusive all others (which is split among all solid waste, sewerage, general obligation bond interest payments, and parks and recreation spending, mainly).

¹⁰ See Gainsborough, 2003, on issues of welfare devolution extending to local governments.

Table 1
Annual Real Changes Per Capita

	State Government		Local Government	
	1992 to 2000	Composition of Change	1992 to 2000	Composition of Change
General Revenues	98.95	100%	71.81	100%
From Federal	26.70	27%	3.65	5%
From State	N/A	N/A	30.74	43%
Taxes	55.68	56%	19.65	27%
Charges	8.99	9%	13.37	19%
Miscellaneous	6.89	7%	4.39	6%
<i>Per Capita Income</i>	<i>760.62</i>			
Direct General Expenditure	54.78	100%	67.49	100%
Education	13.39	24%	37.71	56%
Health	3.52	6%	3.00	4%
Hospitals	(0.42)	-1%	0.85	1%
Welfare	18.13	33%	(1.24)	-2%
Corrections	4.53	8%	1.23	2%
Law Enforcement	1.13	2%	4.40	7%
Highways	4.92	9%	2.51	4%
All Other	9.59	18%	19.02	28%

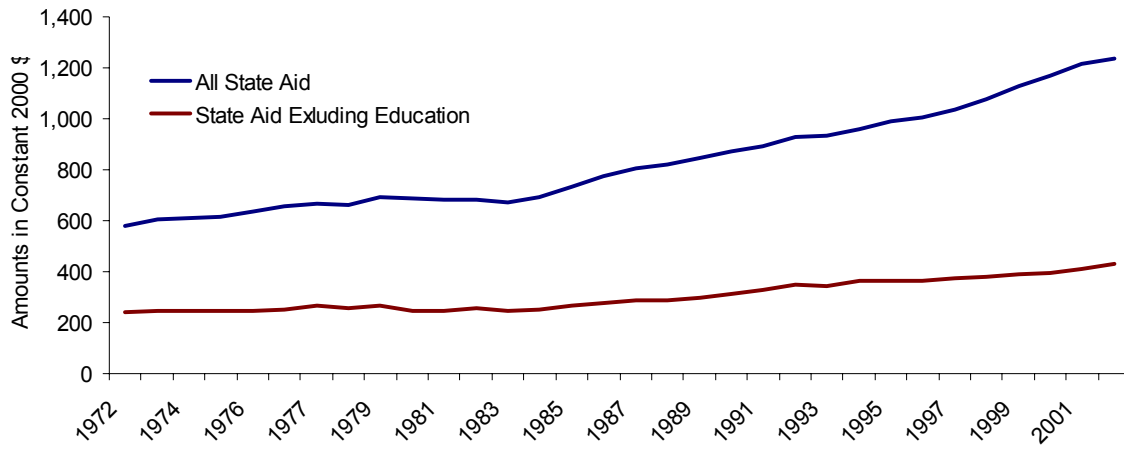
For state governments, taxes led the way in revenue gains, and welfare costs led in direct expenditures. For local governments, general revenue gains attributable to state transfers were more important than tax increases. A question follows as to whether increased federal funds, primarily for Medicaid funding, stimulated by necessity state government tax increases to fund the states' shares of Medicaid match payments or whether states increased taxes were for other purposes.

In Figure 6 the real value of all state aid to local governments per capita has increased since the mid-1980s. From 1992 through 2002, the amount (in constant dollars) increased from \$930 to \$1,235, or by a third. State aid to non-education intentions did not rise as rapidly. In 1992 that amount was \$349, and in 2002 \$429, an increase of 23 percent.

Two elements of modern fiscal federalism have emerged. The majority of the federal aid to states is in Medicaid transfers, with only modest positive change in all other federal assistance categories. For the state governments 65 percent of transfers to local governments are for education, and that percentage has been growing since the mid 1980s. Sorting out the dynamics of federalism compels us to control for these two patterns of change.

Figure 6

Real Per Capita State Aid to Local Government



We get an idea of the interstate variability in these several measures with a basic correlation matrix in Table 2.¹¹ Real gains in state tax collections had a decent correlation with state per capita income gains ($r = .63$), as would be expected if income gains were captured by progressive state tax systems. Growth in state taxes was not influenced strongly by non-welfare federal aid ($r = .32$), however, nor at all from the flow of federal aid for welfare ($r = -.07$). In particular, there was no correlative evidence that state level shifts in Medicaid spending (as measured by the flow of federal welfare receipts) was causing gains on state taxes to make match payments.

Interestingly, and borne by our previous discussion, the strongest correlation on the table is the relationship between total state taxes and the delivery of education-based state aid to local governments ($r = .65$). State government tax effort, at least as it varied across states in a standard manner, appeared to be flowing strongly towards local government as education assistance. That flow appeared doubly beneficial for local governments in the U.S. as state aid for education was strongly correlated with a reduction in local property tax effort ($r = -.62$), the majority of which in the U.S. are generated for education.¹²

¹¹ In anticipation the next portion of this section, all of the variables were transformed into amounts that represented positive and negative shifts in real per capita revenue items. This is accomplished by calculating each state's real change in a particular variable per capita that was in excess of or deficient from the national weighted average. This allows us to identify spatially who were, compared to the national average, gaining or losing ground on a particular measure. Each state's value, then, varies plus or minus around an expected deviation of zero (i.e., the national change component).

¹² These data included all 50 states. When Alaska and Hawaii are excluded because their income and public finance values are often outliers, the relation between real per capita income and state tax collection goes down to $r = .321$, and the relation between state taxes and intergovernmental education aid to local government reduces slightly to $r = .575$. The correlation between state aid and property taxes increases however to $r = -.76$.

Table 2
Table of Correlations: Real Per Capita Shifts, 1992 to 2000

Variables	Total State Taxes	State IG From Federal (Non Welfare)	From Federal (Welfare)	State IG From Federal (Welfare)	Local Property Taxes	IG From State (Non-Education)	IG From State (Education)
Real Per Capita Income	0.631						
IG From Fed (Non Welfare)	0.319						
IG From Fed (Welfare)	-0.065		-0.125				
Property Taxes	-0.109		0.078	-0.020			
IG From State (Non-education)	0.390		0.269	0.097	0.240		
IG From State (Education)	0.650		0.258	-0.048	-0.615		0.161

Figure 7 gives us some of the national distributions of the shifts that were measured in the aggregate. The purpose of this display is to see whether there were geographic clusters of changes. In each, the shaded value represents states that deviated positively (or desirably) from the national expected values (the weighted average rates of change for all states). These values are real amounts per capita per year for the 1992 to 2000 period. The shift in federal Medicaid payments per capita demonstrate large groupings in the southwestern states, the retirement states including Florida, along with Kansas, Missouri, Iowa, Wisconsin, North Dakota, and Montana in the plains region – areas with high elderly and other dependent populations.

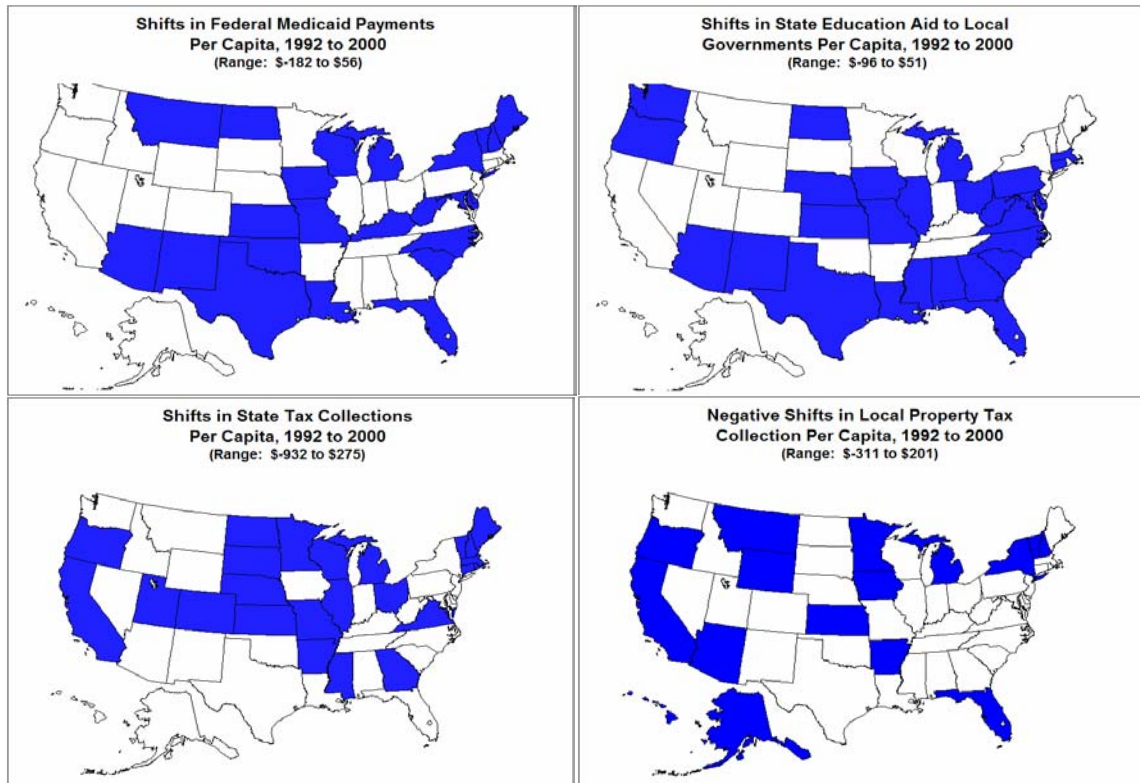
The states with positive shifts in tax collections are somewhat more tightly grouped. Except for Iowa, a very large cohesive block of middle and upper plains states stretching west through Colorado and Utah realized net gains in tax collections.

Shifts in state aid to local government for education also seem to be spatially cohesive. The swath extends from the Great Lake states of Michigan and Ohio over to the Mid and South Atlantic, all through the Gulf states, and on west through Arizona. Another block is evident in the Midwest and in the extreme Pacific Northwest.

Negative shifts in property tax collections per person appear much less spatially cohesive. The majority are northern states, Vermont, New Hampshire, New York, Michigan, Iowa, Minnesota, Wyoming and Montana among them.

Figure 7

Real Annual Shifts in Selected State and Local Indicators, 1992 to 2000



State and Local Government Revenue and Spending Patterns, Fiscal 2000 to 2002

Figure 4 showed the sharp reduction in state government tax collections comparing fiscal 2000 with 2002 and later. We have shown that the expected positive or stimulating effects of federal funds shifting, of devolution in general down to the state level during the 1990s, did not appear to cause major shifts in state government activities during the earlier period.

During the crisis years of 2002 and 2003, however, many states, feeling tax revenue pinched, argued that they were having trouble coming up with their match values for Medicaid to the poor – that a major fiscal crisis was looming regarding their collective abilities to generate enough state revenues to maintain their historic and accumulating obligations for all state spending along with welfare related activities. They urged and argued for federal relief, a bail-out as it were, and an increased federal share of Medicaid payments to tide them over the crisis. They also began to argue strongly for Medicaid spending and health care spending reform in general.

Table 3 gives an idea of the real per capita revenue and spending outcomes comparing 2000 with 2002. All state government taxes declined in the U.S. by almost \$81. These losses were offset strongly by gains of nearly \$67 per capita in federal aid. During this period of fiscal stress, the continued increased flow of federal aid proved beneficial to state accounts. Even though general

revenues were essentially flat at this time, the states still realized almost \$100 in real per capita direct spending increases. Some of these expenditures were made possible by drawing on state rainy day funds that were compiled during better years. Some, in states where it is allowed, was from borrowing. Notably, the states' obligations for welfare spending increased to almost \$45 per capita – 45 percent of the growth in state direct spending. In the previous 1992 to 2000 period, this category averaged just over \$18 per year. The welfare category, 80 percent of which is attributable to Medicaid spending for the low income elderly and disabled recipients, was growing strongly. State direct spending (not intergovernmental) on education was still robust at \$22.54

Table 3
Annual Real Changes Per Capita, Fiscal 2000 to 2002

	State Government	Local Government
	2000 to 2002	2000 to 2002
General Revenues	1.48	64.45
From Federal	66.62	11.49
From State	N/A	24.01
Taxes	(80.77)	19.78
Charges	11.50	10.02
Miscellaneous	1.72	(0.85)
<i>Per Capita Income</i>	(312.27)	
Direct General Expenditure	99.41	92.69
Education	22.54	33.55
Health	0.58	5.84
Hospitals	4.01	5.67
Welfare	44.80	3.86
Corrections	1.50	2.40
Law Enforcement	0.28	5.36
Highways	7.80	3.01
All Other	17.91	33.00

While the states were in a tight fiscal jam, local governments' situation seemed much better. Local governments had \$64.45 in annual per capita gains. State aid was \$24 of that, local taxes nearly another \$20, federal aid increases were \$11.50, and the rest came from increased charges. The positive shift in federal aid reflected flows attributable to increased homeland security funding during the first year of crisis following the events of September 11, 2001. Local spending was also robust and almost 30 percent higher than was the annual real average in the previous 8 year period. Of an increase in direct spending of more than \$92 per capita, more than a third was in education, and about the same amount in the utility-dominated all other category, and the remainder divided among the rest.

Table 4 lists the simple correlations that occurred during this period. None of the more meaningful correlations in the previous period are evident. In particular, positive state taxes were

only slightly associated with real gains state aid to education ($r = .3$), and the strong relationship between state aid and reduced local taxes disappeared.

Table 4
Table of Correlations: Real Per Capita Shifts, 2000 to 2002

Variables	Total State Taxes	State IG From Federal (Non Welfare)	State IG From Federal (Welfare)	Local Property Taxes	IG From State (Non-Education)
Real Per Capita Income	0.142				
IG From Fed (Non Welfare)	0.133				
IG From Fed (Welfare)	0.195	-0.127			
Property Taxes	0.120	0.277	-0.077		
IG From State (Non-education)	0.272	0.277	0.114	-0.078	
IG From State (Education)	0.300	0.165	0.061	0.018	0.240

Conclusion and Discussion

The flow of federal funds into state governments does not appear to be the only federalism story of the 1992 to 2000 period. Although the majority of those fund transfers were for Medicaid recipients and most of that money, accordingly, was spent directly by the state in support of those populations, aid from the federal government for other uses did not correlate with meaningful shifts in state tax capacity or their spending in other categories.¹³

Real growth in state government receipts during a time of rapid economic growth, however, did find its way into a strong correlation with an increase in state education aid to local governments and in reduced property taxes for local governments.

The persistent shifts in state spending for higher education that was evidenced in the tables may need some additional investigation. Since the late 1990s, states have aggressively upped their direct charges for education (tuitions, charges, and fees) at all levels of higher education, which sharply shifts funding for higher education out of tax-based general sources to charge-based general sources. In addition, over this time, institutions of higher education became more and more important as research institutions and recipients of national and private research funding, which in turn leads to increases in their output and their costs.

Real gains in state spending in support of local education, however, likely happen on two fronts: most states are investing directly in local education, especially in services and programs to improve math and science instruction, and in the provision of more technological resources into classrooms. On another front, states are still working out the kinks in their education funding equalization systems that help to offset differential local funding capacities. In all, however, the fraction of state and local effort in support of primary and secondary education is expanding and is a larger fraction of combined budgets than was the case a decade ago.

¹³ Much larger correlations tables were constructed. Federal aid, controlling for Medicaid and non-Medicaid transfers, did not correlate even moderately ($r > .4$) with any state revenue or direct spending item except welfare spending.

The more recent period is muddled. There is no evidence that, on the whole, the states abandoned their commitments to education or to local governments in general during the recent fiscal stress. There is evidence of an increased flow of federal funds into the states, but those funds flowed primarily into Medicaid and into homeland security categories, not into broad state governmental services and capacities. There was evidence that the states maintained their efforts in support of education despite constraints on their receipts during the 2000 to 2002 period.

An argument could be made that without the upped flow of federal Medicaid funds, the states could not have afforded their generosity to local governments, and education in particular. Maybe, but the states' commitments to Medicaid spending rise, per recipient, more slowly than the federal cost, and the states aggressively seek to control health care costs in an attempt to limit their exposure. More research needs to be conducted to sort out the more precise effect of federal Medicaid flows on state accounts. Our findings indicate that they account for a very large fraction of modern increases in state spending. One would reasonably conclude that there is an upward limit to the states' abilities to absorb those increases without it affecting their commitments to other programs and to local governments. And given the massive increase in federal spending during the current administration, there is also a looming upper limit in federal future federal transfers as well.

Research note: this research is ongoing. We originally proposed a local governments dimension, where we were to investigate whether, over the fiscal 1997 to 2002 period, there were differences in the flow of, primarily, state funds into local governments controlling for rural, urban, and metropolitan governments, and whether there were, as a result, differential shifts in local capacity attributable to those flows.

End Notes

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