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ABSTRACT

This paper outlines the major challenges to raising state and local funds for education and other children's services and suggests principles for guiding efforts to answer these problems. It focuses on issues of state and local tax-based strategies for financing education and other children's services, and also discusses general fiscal issues facing state-local governments. Two problem areas in the financing of state and local governments include: (1) the fiscal linkages between state and local governments (school-finance reform and local property-tax relief); and (2) the structural deficits facing state governments. Because state and local resources are constrained, there is a compelling argument for concentrating efforts to improve education on those districts most in need. Increased state involvement in the financing of local governments has implications for both local accountability and the equity and efficiency of the state and local revenue system. If state governments severely limit local government access to the property tax, they also implicitly sever the link between revenue-raising responsibility and spending authority at the local level, and they cause a change in the mix of state and local revenues. The two primary sources of revenue for state governments are individual income and general sales taxes. If the reliance on either or both of these two taxes is to be increased in order to finance property-tax relief, the structures of the two taxes should be evaluated for possible changes that would make the taxes more equitable, efficient, and responsive to economic growth. Information about the Finance Project and its available publications is included. (Contains seven references.) (LMI)

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ISSUES AND CHALLENGES IN STATE AND LOCAL FINANCES

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PREFACE

State and community leaders are under increasing pressure to improve their education, health and welfare systems. If Congress has its way, they will also play a larger role in designing, operating and paying for education and other supports and services for children and their families. The success of any efforts to reform these systems will be determined, in part, by the extent to which they are tied to sound revenue sources.

Most states are in the best financial shape they have been in for years.[1] Revenues and expenditures were higher than originally budgeted in most states during 1993 and 1994, and strong revenue growth has allowed some states to build reserves to their highest levels since 1980. Yet changing demographic and economic conditions, as well as a changing policy landscape, suggest that many states will face significant fiscal and budgetary challenges during the remainder of the decade and beyond. Expected reductions in federal funding will also create considerable pressures for state and local governments to change the way in which they fund education, health and welfare systems.

As policymakers consider whether and how to fill the expected revenue gap, they will need to be aware of the fiscal, legal and political challenges they can expect to face. Governors, legislators and other policymakers will need strategies to prevent the potential erosion of state tax bases due to a variety of economic and demographic changes including shifts in the composition of personal income and movements towards a more service-based economy. They can also be expected to craft legal provisions for dealing with new financing strategies, both those sparked by changes in state revenue bases and those initiated by the changes in the federal-state relationship. And state and local decisionmakers will need to consider not only the legally possible and economically desirable directions for revenue reform but also what is politically feasible in the current environment.

Against this backdrop, The Finance Project's Working Group on Strategies for Generating Revenue for Education and Other Children's Services has prepared a series of studies of systemic revenue generation issues for education and other children's services. It includes:

- *Issues and Challenges in State and Local Finance* -- an outline of the major challenges to raising state and local funds for education and other children's services, suggesting principles that should guide attempts to address these problems.
- *The Effects of Economic and Demographic Changes on State and Local Budgets* -- an analysis of the long-term economic and demographic trends that affect revenue generation, it highlights current and anticipated changes to the economic base and the implications of these changes for the overall mix of state government revenue sources, as well as the most promising sectors and activities for tax revenue growth.

[1] National Conference of State Legislatures and National Association of Legislative Fiscal Officers, State Budget and Tax Actions 1995: Preliminary Report. Denver, CO: National Conference of State Legislatures, July 1995..

- Legal Issues and Constraints Affecting Finance Reform for Education and Related Services -- an examination of the federal and state constitutional and statutory issues that affect the capacity of governments to raise revenue for education and other children's services, including mandates and key legislation which limit revenues, expenditures, and borrowing.
- Toward State Tax Reform: Lessons from State Tax Studies -- a review and analysis of recent state tax commission recommendations in selected states which identifies critical factors to the success of state tax reform commissions, focusing on factors linked to the process of forming a commission and generating the necessary consensus to enact tough reforms.

Taken together these studies paint a vivid picture of the current fiscal context as well as the emerging fiscal and budgetary challenges that states and localities will face over the coming several years. They clarify a number of the critical policy and political issues that will confront governors, state legislatures, educators and others who run programs to serve children and their families. And they highlight a variety of options for reform that policymakers may pursue to improve public revenue generation for education and other children's services.

These papers are part of a larger series of working papers on salient issues related to financing for education and other children's services produced by The Finance Project. Some are developed by project staff; others are the products of efforts by outside researchers and analysts. Many are works in progress that will be revised and updated as new information becomes available. They reflect the views and interpretations of their authors. By making them available to a wider audience, the intent is to stimulate new thinking and induce a variety of public jurisdictions, private organizations, and individuals to examine the ideas and findings presented and use them to advance their own efforts to improve public financing strategies.

The Finance Project was established by a consortium of national foundations to improve the effectiveness, efficiency, and equity of public financing for education and an array of other community supports and services for children and their families. Over a three-year period that began in January 1994, the project is conducting an ambitious agenda of policy research and development activities, as well as policy-maker forums and public education. The aim is to increase knowledge and strengthen the capability of governments at all levels to implement strategies for generating and investing public resources that more closely match public priorities and more effectively support improved education and community systems.

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Executive Director

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INTRODUCTION

Education and other children's services are financed publicly by all levels of government. However, the delivery of publicly financed education and other children's services is the domain of state and local governments, with local governments highly dependent on state and federal government financing. This background piece focuses on issues of state and local tax-based strategies for financing education and other children's services. Given the importance of these services in overall state and local budgets, I also discuss general fiscal issues facing state and local governments. One conclusion from this analysis is that states are operating in a fiscally constrained environment, which may limit their ability to access funds for children's services.

There are two broad areas of major concern in the financing of state and local governments. The two problem areas are:

1) The fiscal linkages between state and local governments. The primary issues here are school finance reform and local property tax relief.
2) The structural deficits facing state governments. These are of concern because they limit the fiscal capability of state governments to accomplish meaningful changes in expenditure policy.

I begin with the fiscal relationship between state and local governments, because it is the more intractable problem and is itself a contributor to the second problem.

STATE-LOCAL FISCAL LINKAGES

With regard to the ability of state and local governments to provide education and other children's services the first broad area of concern focuses on cracks in the fiscal links between state and local governments. While state governments fund a significant portion of local government activities, states also constrain and limit the fiscal prerogatives and abilities of local governments. The many policies often work at cross-purposes and diminish the accountability of government at both levels.

The most important local government unit in terms of children's services and in the magnitude of state involvement in its finances is the local school district. The difficulty in fixing the state-local fiscal link for school districts stems from a desire to address simultaneously three sometimes conflicting goals. State policy-makers want:

1) to relieve fiscal disparities across local jurisdictions;
2) to ensure fiscally viable local governments which are accountable to local voters; and
3) to achieve an equitable and efficient state and local revenue system.

These goals are most germane for school districts, because of the nature of the good provided and the importance of school districts in the overall level of local property taxes. Over 25 years of court cases and academic studies have led to a general consensus that it is undesirable to fund local schools exclusively (and perhaps even primarily) by the local property tax.[1] The reason is, of course, that local property taxes reflect local property wealth. Thus, in a system where schools are totally funded (or nearly so) by local property taxes, the level of spending on education (and, presumably, the quality of education) also depends on property wealth.

This outcome violates many state constitutions and most people's sense of fairness. The idea that a child's public education should not depend significantly on the wealth of the district where he or she lives, which was first clearly articulated in the 1971 *Serrano v. Priest* case, has become an accepted policy goal around the country. There are nearly as many variations in interpretations of this first goal as there are states in the union. In several states, the focus is primarily on guaranteeing an adequate level of education for children in poor districts, rather than equal education across the state (see Van Slyke, Tan, and Orland, 1995). Under this approach, the idea is to "level up" the poor districts rather than "level down" the rich districts.

The leveling-up approach is often justified by reference to the second goal listed above: ensuring accountability of local government.[2] To remain accountable to local voters, local officials must have responsibility for the financing of local goods and services at the margin. That is, the responsibility for securing the last dollar spent on education should rest with the level of government providing the service. If, for example, state government not only funds all local spending, but decides the level of local spending, then local officials can justifiably claim lack of responsibility if local resident-voters are unhappy with the outcome. *If, however, local government officials are responsible for any level of spending (and taxes) above some state-guaranteed minimum level, then local officials are responsible for the outcome and thus accountable to the resident-voters.* In many states, there is concern that local accountability has been lost because of extensive state involvement in local government finances, both through state grants-in-aid and state-imposed limitations on local government fiscal powers.

Another component of the second goal of ensuring local government accountability is to have "fiscally viable" local governments. This goal is derived from the well-known Tiebout theory that a system of numerous, competing local governments results in an efficient provision of public goods. Consumers choose the local governments offering tax-expenditure packages that best meet their preferences, and local governments produce goods and services at the lowest possible costs so as to be able to offer attractive tax-expenditure packages. Such a system of competing local governments requires that local governments have the authority and responsibility to set spending levels and tax rates. In other words, local governments must be fiscally viable.

It is easy to see how the first two goals -- reducing fiscal disparities and ensuring fiscally viable and accountable local governments -- often come in conflict with one another. In an attempt to reduce fiscal inequities across local jurisdictions, states give grants-in-aid

[1] For an early discussion of this issue, see Rubinfeld (1979). For a more recent review of court cases, see Van Slyke, Tan, and Orland (1995).

[2] By fiscally viable government, I mean governments that have reasonable access to sufficient resources to fund the government programs for which they have been given responsibility.

(sometimes block, sometimes matching) and constrain local taxing authority. This state involvement in local finances frequently breaks the link for local governments between spending authority and revenue-raising responsibility. Thus. local governments are rendered unaccountable and fiscally nonviable. This conflict between the two goals is most clearly illustrated in the case of school districts, because of the strong desire to provide equal educational opportunity (hence, heavy state involvement) and the equally strong desire to maintain local control and accountability of this most important local service. The challenge is to achieve the first goal of reducing disparities with minimum interference, along with the second goal of maintaining local government accountability and viability.

It is tempting to think that the difficulties in achieving the first two goals stem from local reliance on the property tax. But the same problems would almost surely arise from local reliance on any tax base. Income and sales tax bases are as likely to result in fiscal disparities as are property tax bases. However, the property tax remains the primary local source of revenue. In many states, the heavy reliance at the local level on the property tax has resulted in relatively high property tax burdens. Because it is more palatable politically, the rhetoric of reform (school finance reform, or state and local tax reform) is often employed when the underlying goal is property tax relief.[3]

This brings us to the third goal of achieving an equitable and efficient state and local revenue system. The replacement of local property taxes with state-level income or sales taxes, a typical proposal for property tax relief, has implications for the equity of the total tax system. In general, sales taxes tend to be inequitable in that poor individuals pay higher average tax burdens than rich individuals, while income taxes tend to contribute to the fairness of the tax system by taxing those with a greater ability to pay at a higher rate than those with less ability to pay. The fairness of the burden of the property tax is more complicated to assess, but the general consensus among economists is that the property tax burden is likely to be borne proportionally to income. *Thus, a change in a tax system that involves a decrease in the reliance on property taxes and an increase in reliance on one of the two large sources of state revenues would have different implications for the fairness of the system, depending upon whether income or sales taxes are the replacement revenue source.*

With respect to other criteria for judging changes in the mix of revenues, similar considerations come into play. In general, sales taxes are deemed to be more efficient than income taxes. In terms of stability, property taxes are generally more stable than sales taxes, which in turn are more stable than income taxes. Of course, the details of the design of each tax influence their scores on all criteria. For example, because Illinois has a flat-rate income tax with a very low personal exemption and no standard deduction, its income tax does not contribute strongly to fairness.

Clearly, the goal of trying to achieve the right mix of revenues (to achieve underlying goals of fairness, etc.) can easily conflict with the goal of trying to relieve fiscal disparities through state grants-in-aid. The difficulty is that property taxes are local taxes, and income

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[3] The idea of reform of taxes being used to justify changes in the level of taxes is well reflected in the numerous state tax study efforts in recent years. See McGuire and Rio (1995).

and sales taxes are largely, but not exclusively, state taxes. So, a decision to reduce reliance on local revenues generally implies a decision to reduce the role of the property tax in the total tax system.

Let me illustrate a few of the issues and possible solutions stemming from the first broad area of concern, namely, the state and local fiscal link. I will use two examples: California, the historic innovator that began the recent era of state and local fiscal reform, and Michigan, the most recent, bold innovator. In both cases, the driving force was a desire for property tax relief, with the result being radical changes in the way schools are financed.

In 1978, California voters passed Proposition 13, which revolutionized the financing of local government in the state. Proposition 13 limited the local property tax rate to 1 percent of assessed valuation, and, more importantly, changed the method of assessing property for tax purposes. Assessed valuation was set equal to the 1976 assessment level and limited to a growth of no more than 2 percent per year unless the property changed hands, at which time the property was assessed at market value. At the time Proposition 13 passed, the state of California had a rather large surplus, and the state agreed to make up for any loss in local revenues. In the mid-1980s, the state chose to give the revenues in excess of the Gann spending limits (imposed by the voters in 1979) back to taxpayers rather than to increase spending on schools. As a result, school districts began to suffer noticeably.[4] In 1988, the voters passed Proposition 98, which compelled the state to establish a minimum level of state funding for aid to schools. Today, California is a state with relatively low property tax burdens, local governments (certainly school districts) that have virtually no control over the levels of spending and taxes, and a state budget that is perhaps more than 90 percent predetermined. The fiscal hands of government, both state and local, are thoroughly tied in California. Whether the California state and local fiscal relationship is one to be emulated by other states is open to debate.

In 1994, Michigan voters approved the final piece of their massive restructuring package, which virtually eliminates local property taxes for schools by replacing them with state sales taxes and state-imposed property taxes. The state aid formula guarantees a minimum level of spending per student and provides for an annual increase in the grant per pupil at the rate of the growth of state revenues. A relatively small number of high-spending districts are allowed to continue to spend above the average by taxing their residential property owners. Thus, for a vast majority of Michigan school districts, the state has become the sole financier of local school districts, and differences in school property tax rates across districts have been virtually eliminated. It is too early to tell whether the Michigan system will deliver on its promises (which include property tax relief and smaller disparities in spending per pupil), but there are already hints that the state will find it difficult to maintain the promised level of state spending on aid for schools (see Courant, Gramlich, and Loeb 1995, and Cutler, Tan, and Downs 1995).

[4] Silva and Sonstelie (1995) document a decline in spending per pupil in California from a level 13 percent above the national average in 1970 to a level of 10 percent below the average in 1990.

A key question is whether states have the financial capacity (and political will) to provide desired levels of property tax relief and redistribution among school districts. Illinois relies heavily on property taxes, which results in relatively high property tax burdens, and it has great disparities in spending per pupil across school districts. In principle, the state foundation aid program for funding schools (which guarantees, through state aid, an adequate level of spending per student regardless of local wealth) would address both of these issues. However, in recent years the state has been incapable of fully funding the foundation program. The difficulties stem from the great demands placed on state government budgets in the areas of health, welfare, and corrections (see McGuire 1991a). This brings us to our second broad area of concern--the structural deficit.

STATE STRUCTURAL DEFICITS

Over the last few decades, partly because of changes in demand and partly because of changes in federal-state fiscal relationships, state governments have become increasingly responsible for providing fast-growing, costly services. In particular, expenditures on health, welfare, and corrections have been growing faster than the rate of inflation and population growth in many states for many years, and these rates of growth are not expected to decline significantly in the near future. At the same time, many states are operating with revenue systems designed for a very different era, when the federal government funded a large share of state and local spending; when the U.S. economy was heavily industrial and services were a smaller share of total employment and consumption; and when people had different expectations about the role of the state in providing services for the needy.

The particulars of the situation differ from state to state, but the broad parameters of the state structural deficit problem appear to be shared across the country. The trend growth rate of state expenditures exceeds the trend growth rate of state revenues--this is the definition of a structural deficit. If a structural deficit exists, a state will constantly face fiscal crises unless the underlying growth rates of spending or revenues are changed. To see this clearly, suppose that a state with an underlying structural deficit manages to balance its budget this fiscal year by changes in the levels of revenues and expenditures. Then, if the fiscal system is put on automatic pilot (that is, no changes to revenue structures or to expenditure program design), expenditures will outstrip revenues eventually or quickly, depending on the severity of the structural deficit problem. A state that has to balance its budget each year will find itself perpetually making tax increases or spending cuts. But unless these tax increases or spending cuts also involve changes to the underlying growth structure of the fiscal system, the solutions will be short-lived.

There are only two approaches to eliminating a structural deficit. Either the growth rate of spending must be decreased (by attacking the forces that drive the fastest-growing expenditures), or the growth rate of revenues must be increased (by changing the structure of major slow-growing revenue sources). It is quite probable that a combination of these two approaches will be needed. Indeed, it would seem not only impractical but also undesirable to solve the problem of double-digit growth rates in spending on medical services by increasing the rate of revenue growth to double-digit levels.

On the revenue side, there are two major sources of revenue for state governments: the individual income tax and the general sales tax. In most states, the individual income tax exhibits a relatively high trend rate of growth. This is because most state income taxes are slightly to moderately progressive in their rate structures; thus, the tax tracks the fast-growing components of the income distribution. The general sales tax in most states exhibits a relatively low trend rate of growth, for two reasons. First, taxable sales (consumption) tend to grow more slowly than income, and second, in most states the sales tax fails to capture a significant amount of fast-growing services.

The structural deficit problem at the state level has implications for all spending programs, including education and other children's services. California and Illinois provide good examples of the difficulty. In California, as already mentioned, state spending on primary and secondary education suffered during the 1980s. Today, after the passage of Proposition 98--which protects K-12 education spending--it is non-entitlement state spending programs (such as higher education) that are suffering. In Illinois, the budget process operates so that primary and secondary education receives the "residual" after other (largely entitlement) programs such as Medicaid are allotted their shares. In recent years, this residual has failed to fund education at an adequate level, as determined by studies of the cost of providing education.

CONCLUSION: GUIDING PRINCIPLES AND OPEN ISSUES

If we put the two broad areas of major concern together--the question of the fiscal relationship between state government and its many local governments, and the difficulty of state governments meeting 21st-century spending pressures with early-20th-century revenue systems--we can see why state governments are having fiscal troubles. States across the country are becoming more involved financially at the local level (whether in providing property tax relief, reducing fiscal disparities across school districts, or increasing state support for local governments), while the fiscal ability of state governments to accomplish anything new appears to be increasingly constrained. The message here is that, while the situation for state governments is not yet dire, the prognosis for the future is not optimistic. A survey of states across the country would find virtually the same set of fiscal problems and questions, but as yet there seem to be no easy answers or solutions to state and local fiscal woes.

I conclude with some thoughts on possible guiding principles and open issues.

Guiding Principles

Because state and local resources are constrained, there is a compelling argument for concentrating efforts to improve education on those districts most in need. School finance reform should focus on property-poor, low-spending districts and on large inner-city districts where the special needs of the city's pupils contribute to a high cost of providing an adequate education. Inner-city schools also warrant attention because the health of metropolitan areas depends on the health of their inner cities. Without good schools in the central cities, middleclass flight to the suburbs will continue, and disadvantaged children will not receive the education they need in order to succeed.

When state governments increase their involvement in the financing of local governments, their actions have implications for both the accountability of local governments and the equity and efficiency of the state and local revenue system. Property taxes are the primary means of fiscal empowerment for local governments. If state governments severely limit local government access to the property tax in an attempt to achieve property tax relief, they also implicitly sever the link between revenue-raising responsibility and spending authority at the local level, and they cause a change in the mix of state and local revenues.[5] The two primary sources of revenue for state governments are individual income and general sales taxes. If the reliance on either or both of these two taxes is to be increased in order to finance property tax relief, the structures of the two taxes should be evaluated for possible changes that would make the taxes more equitable, more efficient, and more responsive to economic growth.

Open Issues

States across the country continue to wrestle with the problems of reducing fiscal disparities for school districts and improving the quality of education in inner cities, while at the same time trying to maintain some amount of accountability at the local level. California and Michigan provide two important case studies of radical changes in the way schools are financed. Are these models of success or failure? Once a basic finance system has been agreed upon that addresses the issues of fairness and accountability, how are the special problems of central city schools to be addressed? Does the answer lie in metropolitan-level government or in more decentralized city school systems?

As states limit local property taxes and replace them with state revenues, the equity and efficiency of the state and local revenue system change. The magnitude of the change can be large, because local property taxes contribute in excess of one half of total tax revenues in many states. What are the implications of the swap of state taxes for local property taxes, and are they well understood by policy-makers and voters? How can structural reform of taxes be accomplished at the same time as major changes in the levels of taxes are contemplated? Lasting structural reform of tax systems remains elusive, since the desire for property tax relief interferes with and complicates the path to an equitable and efficient state and local revenue system.

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[5] For a discussion of the issues surrounding state involvement in local property taxes, see McGuire 1991b.

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THE FINANCE PROJECT

The Finance Project is a national initiative to improve the effectiveness, efficiency, and equity of public financing for education and other children's services. With leadership and support from a consortium of private foundations, The Finance Project was established as an independent nonprofit organization, located in Washington, DC. Over a three-year period that began in January 1994, the project is undertaking an ambitious array of policy research and development activities, as well as policymaker forums and public education activities.

Specific activities are aimed at increasing knowledge and strengthening the nation's capability to implement promising strategies for generating public resources and improving public investments in children and their families, including:

- examining the ways in which governments at all levels finance public education and other supports and services for children (age 0-18) and their families;
- identifying and highlighting structural and regulatory barriers that impede the effectiveness of programs, institutions, and services, as well as other public investments, aimed at creating and sustaining the conditions and opportunities for children's successful growth and development;
- outlining the nature and characteristics of financing strategies and related structural and administrative arrangements that are important to support improvements in education and other children's services;
- identifying promising approaches for implementing these financing strategies at the federal, state and local levels and assessing their costs, benefits, and feasibility;
- highlighting the necessary steps and cost requirements of converting to new financing strategies; and
- strengthening intellectual, technical, and political capability to initiate major long-term reform and restructuring of public financing systems, as well as interim steps to overcome inefficiencies and inequities within current systems.

The Finance Project is expected to extend the work of many other organizations and blue-ribbon groups that have presented bold agendas for improving supports and services for children and families. It is creating the vision for a more rational approach to generating and investing public resources in education and other children's services. It is also developing policy options and tools to actively foster positive change through broad-based systemic reform, as well as more incremental steps to improve current financing systems.

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