

NTA Forum

Perspectives, Ideas and News from the National Tax Association

Number 29, December 1997

Fiscal Capacity, Fiscal Need, and Fiscal Comfort: New Evidence and Its Relevance to Devolution



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**Dedicated to
the Memory of
Janet L. Staton
1936-1997**

Since the founding of the Republic, Americans have continuously debated the proper division of fiscal and regulatory responsibilities among levels of government. The controversy has often involved the concomitant question of the optimal size of government as a whole. Policymakers have quarreled not only over which level of government should do what but also about what government should do.

The most recent chapter of this long-standing dispute—the “devolution” debate—is no exception. The size of government is currently an issue largely because some question the ability and will of state and local governments to assume devolved responsibilities. These doubts are especially troublesome to those who believe that states and their municipalities should pick up where the federal government leaves off. They fear that many states will fail to take on devolved responsibilities in part because they suffer from chronic fiscal stress. They argue that states subject to the most fiscal stress are forced to cut public services to compete in the short run, eroding their long-run competitive position and drawing them into a vicious cycle.

Proponents of devolution note that governments’ reluctance to assume new responsibilities is precisely the reason why government should be smaller and more decentralized. In their view, federal spending has bloated government beyond what citizens in many areas of the country want. If states are given more fiscal independence and responsibility, they will be freer to respond to the preferences of their citizens. As for the problems raised by interstate fiscal disparities, many proponents of devolution believe that, even when the playing field is uneven, interjurisdictional competition induces efficient, responsive, innovative, and self-reliant government. Given political and administrative realities, any federal aid, no matter how well designed to narrow interstate differences in fiscal stress, would weaken these desirable incentives.

If devolution were to proceed as extensively as its most avid supporters would like, which states would have the most difficulty expanding their fiscal domain, should they choose to? How disparate would be the capacity of states to respond?

In order to address this issue, I estimated the fiscal comfort level of each state, using methodologies originally developed by the now-defunct U.S. Advisory Commission on Intergovernmental Relations (ACIR). My estimates are for 1994, the latest year for which all relevant data are available.

Some Key Concepts

Every state, along with its municipal governments, must provide vital public services to those who reside, work, travel, and vacation within its borders. Many states, through no fault of their own, must work relatively hard to meet their fiscal responsibilities, compelled to cope with difficult problems that require costly solutions. For example, some have a high proportion of low-income residents who need cash assistance, special education, and extensive health care. Others may have a large percentage of their population in the school-age bracket of 6 to 18 years, compelling them to spend large per capita amounts on primary and secondary education. Still others, with a large geographic area and widely dispersed population, must spend high per capita amounts on road construction and maintenance. Such conditions intensify *fiscal need*, that is, they

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increase the cost of delivering services or augment the scope of programs that a state must deliver.

On the revenue side, some states are endowed with rich potential tax bases, for example, large income and property tax bases attributable to residents' high average income and wealth, a large potential sales tax base due to physical beauty and man-made attractions that draw visitors, or a rich severance tax base because of high concentrations of extractable minerals or lumber. These conditions augment *fiscal capacity*. *Fiscal comfort* is fiscal capacity relative to fiscal need.

Fiscal Capacity

It is tempting to use personal income to measure a state's fiscal capacity, since we pay our taxes, on whatever base, out of our income. However, personal income fails to take into account the degree to which a state can "export" its tax burden to non-residents. For example, states endowed with large deposits of extractable fossil fuels have a greater revenue-raising capacity than their per capita personal incomes would suggest because they can impose severance and property taxes on oil, gas, and coal companies. These companies can often shift much of the burden of these

taxes onto their customers, who are located throughout the world. If not, the owners, many of whom are not residents, bear the burden. Similarly, Nevada's revenue-raising ability is augmented by its large tourist and gambling industry.

The most sophisticated in-depth analyses of interstate differences in fiscal capacity that attempted to address the limits of the personal income measure were last performed by ACIR. Between 1962 and 1991, ACIR periodically published an index that gauges each state's *relative* fiscal capacity. The methodology, known as the representative tax system (RTS), evaluates tax capacity by estimating the per capita tax yield that a uniform, hypothetical, representative tax system would produce in each state. The resulting yield provides an indicator of the relative richness of the state's potential tax bases. The rather involved methodological details can be found in ACIR (1993) and Tannenwald (1997). Following the ACIR approach, I indexed these relative yields to the national average (set equal to 100). The results for FY1994, along with those for FY1987 estimated by ACIR, are presented in Table 1.

As the table shows, tax capacity has varied widely among the states, exhibit-

Janet L. Staton

Janet passed away on September 10, 1997, after a long, courageous battle against cancer. She was with NTA for 30 years, under three executive directors, and served as Association Secretary for more than a decade.

The National Tax Association stood at the center of Janet Staton's life. She counted many NTA members among her personal friends. She rejoiced over a successful conference or some public recognition of the Association's work, and suffered personal grief when the Association lost a long-time member or experienced a budget shortfall. She guarded the Association's money, integrity, and reputation as though they were her own. Her knowledge of NTA management details was encyclopedic, as was her familiarity with events and people in

the Association's history. With her death, much of NTA's past is forever lost.

Janet's work as Executive Assistant was characterized by high competence and true devotion to managing the Association's business affairs. From her many years of managing the registration desk at NTA conferences, symposia, and workshops, she became personally acquainted with countless NTA members, and she greatly enjoyed these contacts.

Throughout more than 15 years of illness, Janet maintained a positive outlook. She strived heroically to keep up with her NTA duties and always put up a brave front. And she never lost hope that she would eventually conquer the cancer, regain her health, and again pick up her work for NTA.

Frederick D. Stocker

ing a degree of dispersion that supports the anti-devolutionary concerns discussed above. In FY1994, the values of the RTS tax capacity index ranged from a high of 141 in Nevada to a low of 71 in Mississippi. States with extraordinarily high tax capacity include those with large potential income and/or property tax bases (such as Connecticut, Delaware, the District of Columbia, Hawaii, and New Jersey), those blessed with an abundance of extractable minerals (such as Alaska and Wyoming), and those with an unusually high sales tax capacity by virtue of their large tourist industry (such as Hawaii and Nevada). States with the lowest tax capacity tend to be concentrated in the South and have low capacity indices for all three major state and local broad-based taxes: property, personal income, and general sales.

A related concept to tax capacity is "revenue capacity," measured with the representative revenue system (RRS), which is the same as RTS but also takes into account a state's relative capacity to

Search Begins for *NTJ* Editor

Joel Slemrod has announced that after serving as *National Tax Journal* editor for six years he will step down effective June 1, 1998. NTA President Wayne Eggert has appointed a Search Committee for the editorial position that includes Julie Collins, Bill Fox, Jane Gravelle, Joel Slemrod, Bob Strauss, and Emil Sunley.

NTA members are invited to submit recommendations for the position **no later than January 20** to:

William F. Fox
Chair, NTJ Search Committee
Center for Business and Economic Research
University of Tennessee
100 Glocker Business Building
Knoxville TN 37996
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The Search Committee will review all recommendations. Candidates should have superior reputations as scholars, capacity to judge quality submissions across the range of public finance, balanced and fair perspective, strong networks of peers across different public finance interests, and willingness to give the *Journal* high priority among competing demands.

Chart 1
Mean Absolute Deviation from National Average (100), RTS Fiscal Capacity

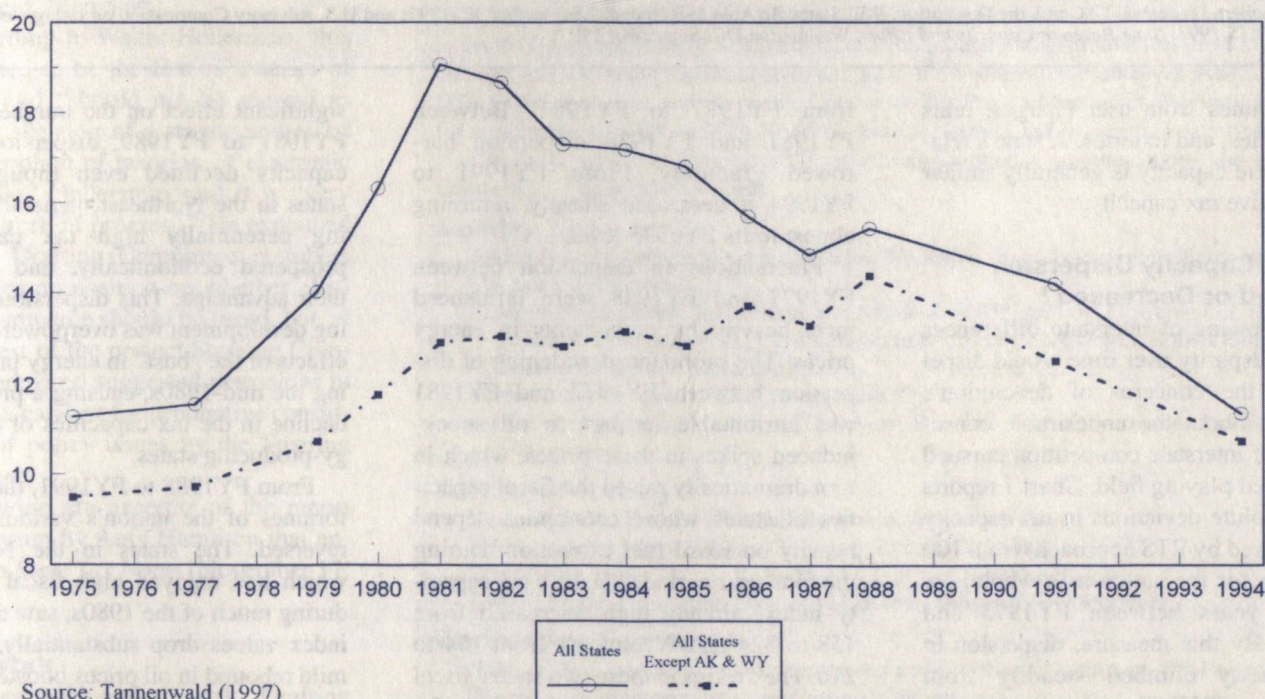


Table 1
Index of Tax Capacity, 1994 and 1987, by State (National Average = 100)

States	1994 (1)	Rank # (2)	1987 (3)	Rank # (4)	States	1994 (1)	Rank # (2)	1987 (3)	Rank # (4)
NV	141	1	110	12	MT	96	27	87	37
CT	136	2	139	2	GA	95	28	94	26
AK	131	3	169	1	TX	95	28	99	20
WY	128	4	137	3	NE	95	28	91	31
NJ	128	4	122	7	VT	95	28	103	17
HI	125	6	113	10	MO	94	32	91	31
DC	124	7	122	7	RI	94	32	96	24
DE	116	8	124	5	ND	93	34	90	34
NH	113	9	123	6	IA	93	34	84	41
MA	112	10	127	4	AZ	93	34	100	19
CO	110	11	111	11	LA	92	37	86	40
MD	107	12	109	13	NC	91	38	90	34
IL	107	12	97	22	SD	91	38	78	46
CA	105	14	117	9	TN	90	40	84	41
MN	104	15	104	16	ID	90	40	77	47
VA	104	15	102	18	NM	90	40	87	37
WA	103	17	99	20	ME	89	43	97	22
MI	101	18	95	25	OK	87	44	93	27
NY	101	18	108	14	SC	86	45	80	43
FL	100	20	105	15	UT	85	46	79	44
OR	98	21	92	29	KY	85	46	79	44
IN	97	22	87	37	AL	83	48	75	49
PA	97	22	92	29	AR	81	49	75	49
KS	97	22	93	27	WV	81	49	77	47
WI	97	22	88	36	MS	71	51	65	51
OH	97	22	91	31					

Sources: Robert Tannenwald, "Come the Devolution, Will States Be Able to Respond?" September 12, 1997; and U.S. Advisory Commission on Intergovernmental Relations, *RTS 1991: State Revenue Capacity and Effort*, Washington DC, September 1993.

raise revenues from user charges, rents and royalties, and lotteries. A state's relative revenue capacity is generally similar to its relative tax capacity.

Has Tax Capacity Dispersion Increased or Decreased?

A narrowing of interstate differences in fiscal disparity over time would dispel some of the concerns of devolution's opponents about the undesirable consequences of interstate competition pursued on a slanted playing field. Chart 1 reports mean absolute deviations in tax capacity (as measured by RTS approach) from 100 (the value for the nation as a whole) for selected years between FY1975 and FY1994. By this measure, dispersion in tax capacity climbed steadily from FY1975 to FY1977 and quite steeply

from FY1977 to FY1981. Between FY1981 and FY1988 dispersion narrowed gradually. From FY1991 to FY1994 it decreased sharply, returning almost to its FY1975 level.

Fluctuations in dispersion between FY1977 and FY1988 were influenced most heavily by movements in energy prices. The pronounced widening of dispersion between FY1977 and FY1981 was attributable in part to oil shock-induced spikes in these prices, which in turn dramatically raised the fiscal capacities of states whose economies depend heavily on fossil fuel extraction. During the four-year period, Alaska's tax capacity index, already high, increased from 158 to 324 and Wyoming's from 154 to 216. The swings in these two states' fiscal capacity were so large that they exerted a

significant effect on the numbers. From FY1981 to FY1989, dispersion in tax capacity declined even though many states in the Northeast, generally enjoying perennially high tax capacities, prospered economically, and widened their advantage. This dispersion-enhancing development was overpowered by the effects of the "bust" in energy prices during the mid-1980s, causing a precipitous decline in the tax capacities of the energy-producing states.

From FY1988 to FY1991, the relative fortunes of the nation's various regions reversed. The states in the Northeast, which had enjoyed high fiscal capacity during much of the 1980s, saw their RTS index values drop substantially, while a mild rebound in oil prices boosted the tax

(continued on page 7)

Electronic Commerce Project Releases First Report

The Steering Committee of NTA's Communications and Electronic Commerce Project held a national public forum in Chicago on November 12, in conjunction with the 90th Annual Conference on Taxation. More than a hundred representatives from industry, government, and research and taxpayer organizations attended the day-long session at which the first report of the project's Drafting Committee was released.

The 43-page report reflects the preliminary thinking of committee members on several directions that a model state retail sales tax statute might take. The report also contains the committee's first attempt at developing possible statutory provisions, along with explanation of the purpose of each provision.

The Committee drafted the proposals as members of the project committee, not as representatives of their companies and institutions. The members are James R. Eads, Jr., AT&T; Harley Duncan, Federation of Tax Administrators; Walter Hellerstein, University of Georgia Law School; Andrea Ireland, Netscape; Paull Mines, Multistate Tax Commission; and Bruce Reid, Microsoft.

According to Walter Hellerstein, this is expected to be the first of a series of reports, and "should not be viewed as even the skeleton of a statute addressed to the problem of taxation of electronic commerce." Hellerstein said it is "very much a work in progress." He explained that the Drafting Committee members have taken no position on whether electronic commerce should be taxed, but, at the request of the project Steering Committee, prepared suggested provisions to serve as a catalyst for productive consideration of policy issues by the Steering Committee.

Following are excerpts of the report on the forum by Amy Hamilton that appeared in *State Tax Notes* (November 17, 1997).

Framework

In approaching their task, Drafting Committee members tried to be faithful

to a number of commonly accepted tax policy objectives—though it must be recognized that it is often impossible to satisfy all of these objectives at once, Hellerstein said.

The Drafting Committee members recognize that some of their proposals may require implementing federal legislation and that the provisions they have drafted reflect only a few of the many solutions that might be advanced, Hellerstein said. Drafters also believe that a viable solution to state taxation of electronic commerce must apply to local taxation of such commerce.

The Proposals in Brief

The proposals include nexus and sourcing provisions administered through a billing address regime implemented through congressional legislation. The proposal is designed to implement a tax-

ing regime in which nexus is generally established over the out-of-state vendor of electronically transmitted information and services in the state of the purchaser's billing address.

The out-of-state vendor would be required to make reasonable and good faith efforts to determine the address, but otherwise would be absolved of any responsibility to determine such address or pay a tax to the destination state. The proposal includes a "throwaround" rule for sales involving purchasers whose billing address cannot be determined by reasonable or good faith efforts; a throwback or throwaround rule for sales into tax haven jurisdictions; and a de minimis rule for certain vendors.

Clearinghouse

Another proposal is designed to create a state tax information clearinghouse to

Mark Your Calendar

IPT/NTA Meeting February 1-4 in LaJolla

The Institute for Professionals in Taxation and the National Tax Association will hold the joint biennial symposium on sales taxation February 1-4. The Conference will be held at the La Jolla Marriott (619-587-1414 or 1-800-228-9290). Make reservations **before January 5, 1998** to get the Conference rate of \$125 (single) or \$138 (double). Registration fees are \$250 for government and university representatives and \$275 for business representatives. Add \$25 for the NTA Communications and Electronic Commerce Tax Project Meeting on February 4, and \$50 for non-members of IPT or NTA. *Watch the mail for details and registration materials.*

The theme of the conference is "Transactions Taxation: Communications and Electronic Commerce." The sessions include:

Monday, February 2

Taking Stock of Where We Are and What We Know about Transactions Taxes on Electronic Commerce

Revenue Implications, Federalism, and Fairness—(William Fox, University of Tennessee;

Ernest J. Dronenburg, Jr., California State Board of Equalization; Robert Goldman, Vickers Madden & Goldman)

International Perspective (Jeff Owens, OECD)

Perspectives of the Stakeholders (Taxpayers, Retailers, State Government, Local Government)

Tuesday, February 3

Nexus and Due Process (Kendall Houghton, Alston and Bird)

Administrative Issues (Wayne G. Eggert, Lucent Technologies Inc.)

Compliance Issues (James R. Eads, AT&T; Bruce Reid, Microsoft)

Toward Model Legislation (Walter Hellerstein, University of Georgia)

Wednesday, February 4

National Tax Association Communications and Electronic Commerce Tax Project (Steering Committee meeting and open Public Forum)

facilitate and improve the collection of state and local use taxes on electronic commerce through enhanced enforcement of existing use tax laws. "The proposals that we have advanced here are not intended to result in a data base maintained by any government authority to determine who is buying what electronically," Hellerstein said.

Under this proposal, a person or business that sells tangible personal property or delivers services in interstate commerce by means of the Internet and does not maintain a physical business presence in the state or local jurisdiction into which sales are made would be required to report information concerning the sale to the clearinghouse. The proposal would apply only to transactions for which no sales or use tax has been collected or paid.

The required reports to the clearinghouse would include: the purchaser's name; the address to which the bill of sale is sent; the address to which goods or services are delivered; a description of goods or services sold; the amount paid for the purchase; the amount of any additional charges; and information on any tax exemption claimed by the purchaser.

Any information that identified a specific seller or purchaser could not be divulged by the clearinghouse; violation or unauthorized release of information would constitute a federal crime. Compliance with the act would not be considered in the determination as to whether a seller of goods or services has established nexus in any state or local jurisdiction. This proposal would contain a de minimis rule for certain sellers.

Additional Regimes

The report also includes a proposal that contains two detailed situs rules. The first applies to purchases for personal consumption and purchases not known to be by businesses that are registered in the taxing state. The second rule applies to purchases by businesses that are known to be registered in the taxing state. The justification for adopting two such rules is that business purchases might otherwise be subject to manipulation by arrangements designed to ensure that the situs of the sale would be in a state not taxing the sale of electronically transmitted information or services.

John Shannon Receives First Steven D. Gold Award

John Shannon is the first recipient of the annual Steven D. Gold Award, given jointly by the Association for Public Policy and Management, National Conference of State Legislatures, and the National Tax Association. NTA presented the award at the 90th Annual Conference luncheon on November 10.

The award was created in Steve Gold's memory to honor professionals who have made significant contributions to state and local fiscal policy and whose work spans the interests of scholars, practitioners, policymakers, and advocates with great integrity and evenhandedness.

John Shannon has taught at a number of universities, has been a state government official, and was Assistant Director and Executive Director of the U.S. Advisory Commission on Intergovernmental Relations. Those who know John know his reputation for coining many a fiscal phrase. In making the award presentation, NTA Executive Director Bob Ebel introduced John with a few old favorites—going through fiscal windshields, catching fiscal pneumonia, blood on the teeth of hard fiscal conservatives, economic hemorrhages, fiscal boomerangs, regressive stingers, racing fiscal motors, taking fiscal blood pressure, avoiding fiscal handcuffs, and calling Uncle Sam the fat boy on the intergovernmental block.

In a letter read by Judy Zelio of NCSL, JoAnn Gold expressed her gratitude for the organizations' establishing the award and said, "Anyone who has heard Steve speak or who has read something Steve wrote can bear witness to the fact that very few speeches he gave or articles he wrote were without reference to a contribution made by John Shannon. I know that Steve considered him a beacon in all the areas for which he is being remembered today.... I know he would have been pleased to know that NTA was recognizing the outstanding contributions of John Shannon to the field of public finance and would have been the first in line to list the influences John had in his work."

Positions Available

Ian Axford Fellowships in Public Policy (New Zealand). The Commonwealth Fund of New York invites applicants for the 1999 fellowships. The deadline is March 25, 1998. The fellowships are for American professionals in mid-career to study, travel, and gain practical experience in public policy in New Zealand, including economic, social and political reforms and government management. Applicants must be U.S. citizens. For information and an application, contact Robin Osborn, The Commonwealth Fund, 1 East 75th Street, New York NY 10021-2692 (ro@cmwf.org) or the Fund's website at <http://www.cmwf.org>.

Senior Tax Manager, Charles Schwab. Responsibilities: tax research and planning for international transactions and compliance; calculation of earnings/profit, form 5471, foreign tax credits, subpart F, and related issues; tax audits relating to foreign affiliates. Requirements: Master's degree in tax with minimum 5-6 years Big 6 tax experience (3 in international); research, organizational and problem-solving skills; ability to handle several projects. CPA with securities industry background preferred. Send resumes to Charles Schwab & CO., Inc, Office of Human Resources Attn: EK/97-1377, PO Box 7208, San Francisco CA 94120-7208 (FAX 415-627-7316).

Internal Revenue Service, Statistics of Income (SOI) Division has entry-level openings for economists, computer specialists, and mathematical statisticians to work in Washington DC on teams that conduct statistical studies. Applicants should be U.S. citizens and have a Bachelors or Masters degree in economics, mathematics, statistics, computer science, information systems, or operations research (with at least a B average). Contact Tom Petska, Chief, Special Studies and Publications Branch, at (202) 874-0395 or tom.petska@wpgate.irs.gov.

(continued from page 4)

capacities of the energy-producing states. As a result, dispersion further narrowed. Between FY1991 and FY1994, a 10-point decline in California's tax capacity index, along with smaller declines in other traditionally high-capacity states like New York, Texas, Florida, Ohio, and Washington, produced a sharp narrowing in dispersion. (Declining oil prices were a contributing factor—Alaska's index declined 44 points.)

The large effect of swings in oil prices on dispersion in tax capacity is evident when one removes Alaska and Wyoming from the computations (dotted line in Chart 1). In every year, dispersion is narrower, especially between FY1979 and FY1985 when fluctuations in oil prices were especially pronounced. Year-to-

year variation in dispersion is also much smaller. Finally, dispersion in the 49-state sample exhibited a generally upward trend through FY1988, a reflection of the relatively robust growth of California and states with traditionally high fiscal capacity in the Northeast. The dotted line indicates that the narrowing in dispersion since FY1988 is a reversal in trend, not a continuation.

Fiscal Need

ACIR's methodology for evaluating fiscal need, the "representative expenditure" approach (RES) was developed by Robert Rafuse (1990). Analogous to the representative tax system methodology, analysts implementing RES pose the following questions: (1) What are the characteristics of a representative bundle of state and local spending functions? (2)

What constitutes a standard level of services for each function? and (3) What would each state and its municipalities have to spend, in per capita terms, to provide this standard bundle and level of services? The amount for each state is divided by that for the nation as a whole and multiplied by 100 to construct a fiscal need index. The only year for which ACIR constructed this index was 1987.

In that year and in 1994, states with high fiscal need (Table 2) tended to be those with a high incidence of poverty and/or a large proportion of school-age population. These factors are the primary determinants of need for primary and secondary education and public welfare, the two largest functions of state and local governments, and an important determinant of the need for health and hospitals. (Together, these three functions

Table 2
Index of Fiscal Need, 1994 and 1987, by State (National Average = 100)

States	1994 (1)	Rank # (2)	1987 (3)	Rank # (4)	States	1994 (1)	Rank # (2)	1987 (3)	Rank # (4)
DC	116	1	103	16	WY	96	27	102	20
LA	115	2	110	4	MN	96	27	98	31
CA	110	3	101	23	SC	96	27	103	16
TX	110	3	110	4	NJ	95	30	93	42
NY	107	5	95	40	UT	95	30	105	11
NM	107	5	111	3	FL	94	32	93	42
MS	105	7	113	2	MD	94	32	97	35
AK	104	8	121	1	VA	94	32	99	27
KY	104	8	108	8	ND	93	35	105	11
MI	104	8	108	8	NV	93	35	96	36
GA	104	8	109	6	WA	93	35	99	27
AL	102	12	109	6	PA	93	35	90	45
OK	102	12	104	14	MT	91	39	102	20
CT	101	14	92	44	OR	91	39	98	31
WV	101	14	103	16	MA	90	41	87	49
AZ	100	16	103	16	WI	89	42	94	41
MO	100	16	100	24	DE	88	43	96	36
IL	100	16	102	20	IA	88	43	96	36
TN	99	19	104	14	CO	88	43	98	31
IN	99	19	99	27	RI	88	43	86	50
OH	99	19	100	24	NE	86	47	96	36
KS	99	19	98	31	NH	86	47	85	51
NC	97	23	99	27	HI	85	49	90	45
ID	97	23	100	24	ME	85	49	89	47
AR	97	23	106	10	VT	83	51	89	47
SD	97	23	105	11					

Sources: Robert Tannenwald, "Come the Devolution, Will States Be Able to Respond?" September 12, 1997; and U.S. Advisory Commission on Intergovernmental Relations, *Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity*, Washington, DC, December 1990.

Table 3
Index of Fiscal Comfort, 1994 and 1987, by State (National Average = 100)

States	1994 (1)	Rank # (2)	1987 (3)	Rank # (4)	States	1994 (1)	Rank # (2)	1987 (3)	Rank # (4)
NV	152	1	147	2	PA	104	26	102	21
HI	147	2	126	9	ND	100	27	86	38
CT	135	3	152	1	IN	98	28	88	34
NJ	135	3	131	7	OH	98	28	91	29
WY	133	5	134	6	KS	98	28	95	24
DE	132	6	128	8	MI	97	31	88	34
NH	131	7	144	4	NY	94	33	113	13
AK	126	8	139	5	MO	94	33	91	29
CO	125	9	113	13	SD	94	33	75	45
MA	124	10	145	3	NC	94	33	91	29
MD	114	11	112	16	AZ	93	37	97	23
VT	114	11	115	12	ID	93	37	77	43
WA	111	13	100	22	GA	91	39	87	36
VA	111	13	104	20	TN	91	39	81	40
NE	110	15	94	26	SC	90	41	76	44
WI	109	16	93	28	UT	89	42	75	45
MN	108	17	106	19	TX	86	43	90	32
OR	108	17	94	26	OK	85	44	90	32
IL	107	19	95	24	NM	84	45	78	41
DC	107	19	119	10	AR	84	45	70	49
RI	107	19	112	16	KY	82	47	73	48
FL	106	22	113	13	AL	81	48	69	50
IA	106	22	87	36	WV	80	49	75	45
ME	105	24	109	18	LA	80	49	78	41
MT	105	24	85	39	MS	68	51	57	51

Sources: Robert Tannenwald, "Come the Devolution, Will States Be Able to Respond?" September 12, 1997; and U.S. Advisory Commission on Intergovernmental Relations, *Representative Expenditures: Addressing the Neglected Dimension of Fiscal Capacity*, Washington, DC, December 1990.

accounted for 49 percent of all state and local direct spending in FY1994.) Certain states, such as California, District of Columbia, Louisiana, and New York also ranked high in terms of fiscal need in part because of unusually high crime rates, an important determinant of the need for police and corrections. States exhibiting low fiscal need tended to have small populations, such as Maine, Vermont, Nebraska, New Hampshire, Hawaii, Delaware, and Rhode Island.

In both years, dispersion in fiscal need is narrower than in fiscal capacity. In addition, there have been dramatic changes in the fiscal needs of many states. Over the seven-year period, the index of fiscal need rose in California and the Northeast states, where rates of economic growth lagged the nation as a whole. At the same time, the index fell in

many states located in the South, Rocky Mountains, and Great Plains, where economic growth was relatively rapid.

Correlation between Fiscal Capacity and Need

Devolution's opponents would be less concerned if states facing the most severe fiscal need enjoyed the most fiscal capacity. As Chart 2 shows, the opposite was true in FY1994. Only Alaska, California, and the District of Columbia ranked high on both measures (upper right quadrant). Several southern states, as well as New Mexico, Oklahoma, and Texas, suffered from both low capacity and high need (lower right quadrant). However, several states with weak fiscal capacities faced relatively mild need, such as Maine, Nebraska, North Dakota, South Carolina, and Vermont (lower left quadrant). The

most fortunate states, enjoying both ample capacity and little need, included Colorado, Delaware, Hawaii, Maryland, Massachusetts, New Hampshire, New Jersey, Nevada, and Wyoming (upper left quadrant). Overall, there was a slightly negative correlation between capacity and need, not statistically different from zero. The negative correlation between the two was stronger in FY1987, although still statistically insignificant.

Fiscal Comfort

An index of fiscal comfort for FY1994 and FY1987 was created for each state by dividing its index of fiscal capacity by its index of fiscal need and multiplying by 100 (Table 3). The least fiscally comfortable (most fiscally stressed) states are concentrated in the South. The most fiscally comfortable

states tend to be those with the highest fiscal capacity, except Maine, Montana, Rhode Island, Vermont, and Wisconsin. Given the slightly negative correlation between fiscal capacity and fiscal need, the dispersion in fiscal comfort exceeds the dispersion in fiscal capacity, a fact that reinforces the concerns of devolution's detractors. However, variation in fiscal comfort was lower in FY1994 than in FY1987.

Fiscal Comfort, Tax Effort Indices, and Interstate Differences in Preferences for Service Levels

As noted in the introduction, diversity across states in preferences for the size of state and local government is a key issue in the debate over devolution. Both supporters and detractors worry that such diversity is substantial, but they disagree over what to do about it. Proponents of decentralization contend that the nation would be better off giving citizens an opportunity to realize their diverse preferences rather than have the central

government suppress differences. Opponents fear that states with preferences for limited government would fail to provide levels of service consistent with the national interest.

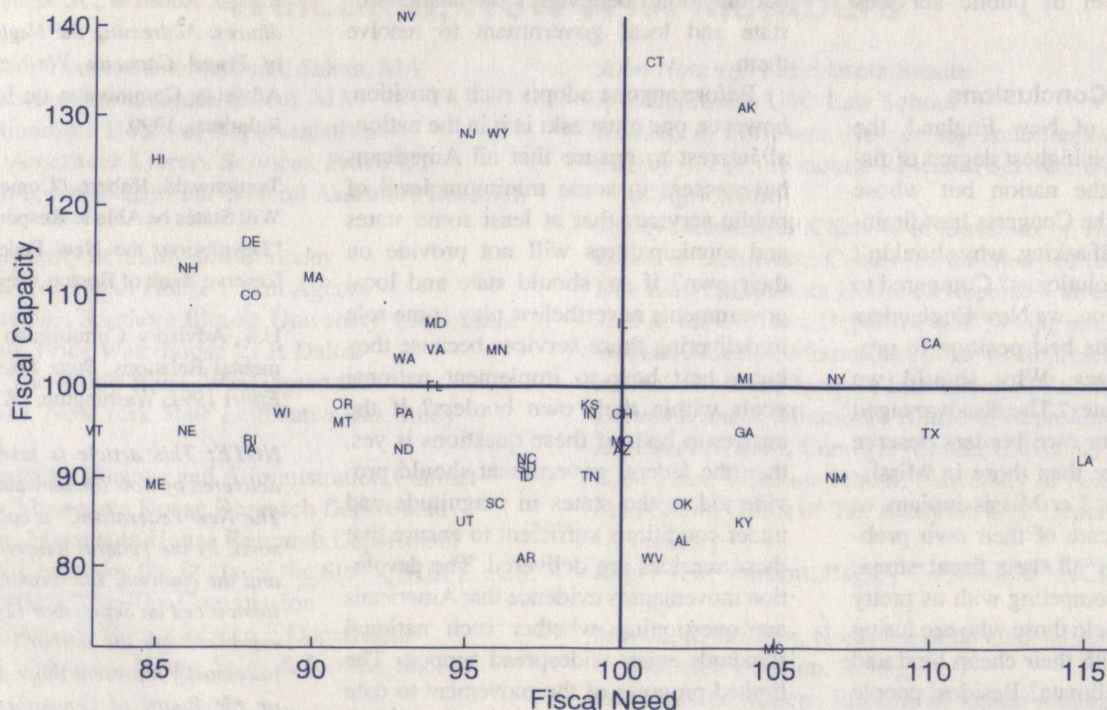
The extent of diversity in preferences can be estimated roughly from the measures of fiscal capacity and comfort presented in this section. Other things equal, states with low capacity relative to need (low comfort) are compelled to spend a relatively high fraction of their tax bases to provide a given level of public services. Consequently, if preferences for levels of state and local public services were similar across states, one would expect states with low levels of fiscal comfort to tax their revenue bases relatively intensively, that is, to exert a relatively high tax effort. A lack of correlation, or a negative one, between fiscal comfort and tax effort would imply that fiscally uncomfortable states prefer lower levels of government.

Following ACIR's methodology, each state's tax effort was computed by divid-

ing its total tax (or own-source revenue) collections by the amount that it would raise under RTS (RRS). This ratio was then multiplied by 100 to create an index of tax (revenue) effort for which the value of the nationwide average is set equal to 100. As shown in Table 4, New York and the District of Columbia exert the most tax effort by far.

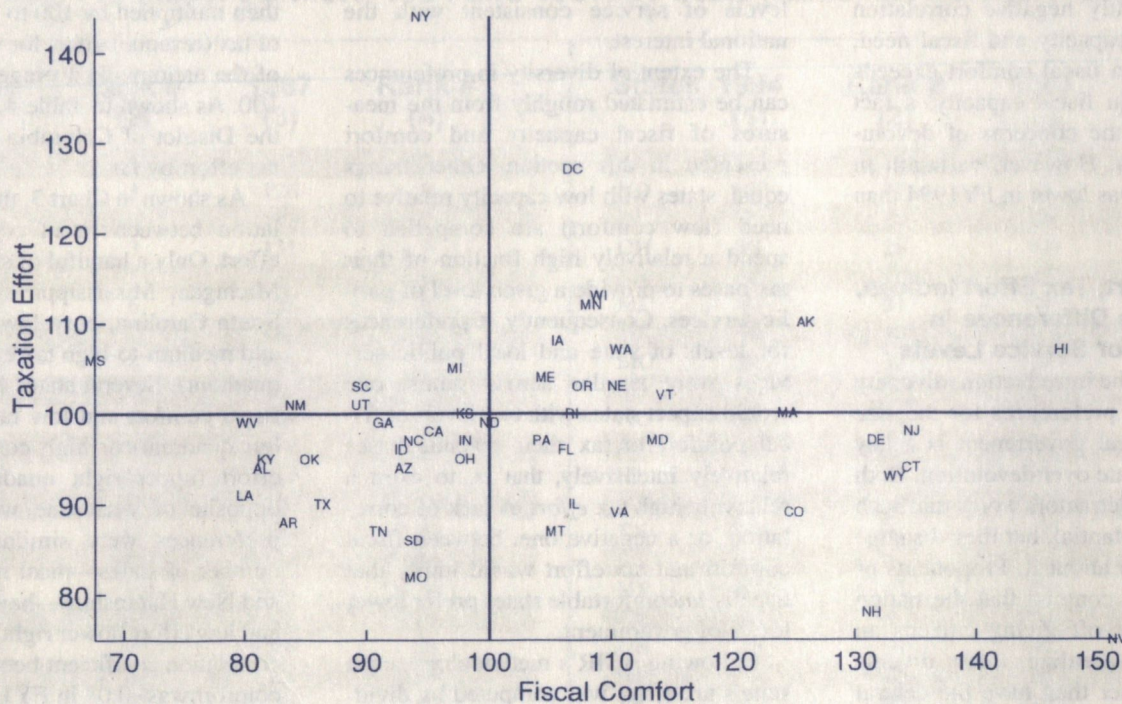
As shown in Chart 3, there is no correlation between fiscal comfort and tax effort. Only a handful of states, including Michigan, Mississippi, New York, and South Carolina, have low fiscal comfort and medium-to-high tax effort (upper left quadrant). Several states have either low fiscal comfort and low tax effort (lower left quadrant) or high comfort and high effort (upper right quadrant)—just the opposite of what one would expect if preferences were similar. However, a number of states—most notably Nevada and New Hampshire—have high comfort and low effort (lower right quadrant). The correlation coefficient between effort and comfort was -0.01 in FY1994, indicating

Chart 2
The Correlation Between RTS Fiscal Capacity and Fiscal Need, FY 1994



Source: Tannenwald (1997)

Chart 3
The Correlation Between RTS Fiscal Comfort and Taxation Effort, FY 1994



Source: Tannenwald (1997)

no significant correlation between comfort and the level of public services preferred.

Summary and Conclusions

As a resident of New England, the region enjoying the highest degree of fiscal comfort in the nation but whose political clout in the Congress has diminished, I find myself asking: why shouldn't I be an ardent devolutionist? Compared to the rest of the nation, we New Englanders are generally in the best position to provide for ourselves. Why should we subsidize other states? The disadvantaged residing within our own borders deserve our attention more than those in Mississippi or Alabama. Let Mississippians or Alabamians take care of their own problems. Frankly, for all their fiscal stress, they seem to be competing with us pretty well. Should we help those who are luring our companies with their cheap land and labor and warm climate? Besides, people in the South, however fiscally stressed their states may be, like small government. They may lack fiscal resources and

have to contend with difficult problems, but they don't believe it's the business of state and local government to resolve them.

Before anyone adopts such a position, however, one must ask: is it in the national interest to ensure that all Americans have access to some minimum level of public services that at least some states and municipalities will not provide on their own? If so, should state and local governments nevertheless play some role in delivering these services because they know best how to implement national goals within their own borders? If the answer to both of these questions is yes, then the federal government should provide aid to the states in magnitude and under conditions sufficient to ensure that these services are delivered. The devolution movement is evidence that Americans are questioning whether such national standards enjoy widespread support. The limited progress of the movement to date suggests that many citizens still cling to such standards.

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- NOTE:** This article is taken from a paper delivered by Bob Tannenwald at "Devolution: The New Federalism," a colloquium cosponsored by the Federal Reserve Bank of Boston and the National Tax Association, held at the Boston Fed on September 12, 1997. The views expressed are the author's only and do not necessarily represent those of the Boston Fed or the Board of Governors of the Federal Reserve System.

NTJ Special Anniversary Issue Celebrates a Half-Century

In honor of the 50th Anniversary of the *National Tax Journal*, Editor Joel Slemrod commissioned a special set of articles, which will appear in the December issue. In his "Note from the Editor," Joel writes:

This 50th Anniversary issue is devoted to looking backward, looking forward, and looking across the ocean. The lead article, by Richard Goode, compares the contents of recent issues of *NTJ* to early issues, offering a window onto the changes in the field of public finance. Next, Harvey Rosen, author of today's best-selling public finance textbook, compares his work to a leading textbook of 50 years ago—*Public Finance* by Harvey Lutz—to gauge the changes in what we teach our students who will be filling the

next 50 volumes of *NTJ*. Charles E. McLure, Jr., then casts his glance forward, discussing the pressures on state sales tax policy arising from technological change in the communication and information sectors.

This issue's Symposium looks across the Atlantic from both directions. First, the American economist William Gale examines the British tax system in search of lessons for the U.S. tax system. Then British economist Michael Keen looks over our system with a critical eye, knowing that many in Britain see some (certainly not all!) features that are worthy of emulation. The Symposium was commissioned jointly with the British journal *Fiscal Studies* and will be published simultaneously in both journals.

This issue also includes a Master Index of all 50 volumes of the *National Tax Journal*. Finally, a short note lists the most cited *NTJ* articles of the last half-century.

I am especially grateful about the personal links that this issue has with the first issue of the *National Tax Journal*. The assistant editor of Volume 1 was Richard Goode, who is author of the lead article in this issue. The editor of the maiden issue was Roy Blough. Mr. Blough, still active at the age of 96, toyed with the idea of contributing an article to Volume 50 but ultimately decided to offer a note. The message from then NTA President George Mitchell that appeared in the March 1998 issue is largely reproduced in the Gems section of this Anniversary issue.

Welcome, New NTA Members

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