

# The Federal Budget and the States in Fiscal Year 1995

## A. Framing the Debate

There is a rising refrain from Washington and state capitals around the country concerning the equity of the geographic distribution of Federal domestic spending program expenditures. It is a fact lost on almost no one that the share that a state's citizens and businesses receive of the approximately \$1.2 trillion in domestic Federal spending, and the share that a state's taxpayers pay of a roughly equal amount collected in Federal taxes, can have a substantial net impact on the overall level of economic activity in the state. Nor is it any great secret that these impacts vary considerably across states. The Federal government's grants, purchases, and expenditures on the one hand, and its tax collections on the other, do have a major impact on the geographic location of economic activity across the country. Citizens in some states receive net inflows of Federal expenditures (in excess of their Federal tax payments) equal to over 15 percent of their income; in other states, there are net outflows of nearly 10 percent. Of course, funds expended in a given state are generally respent in the same geographic area (as, for example, when Federal wage-earners, social security recipients, and employees of defense contractors buy food, housing and other goods and services near where they live). Considering both the initial net impacts of Federal flows of expenditures and taxes, and these "multiplier" effects from how the funds are re-spent, the Federal government is a major force in the geographic distribution of economic activity.

It should be no surprise, then, that concerns about whether states receive a fair proportion of Federal expenditures — or pay more than their fair share of Federal costs

— have become a prevalent feature of Federal policy debates. Congressional delegations have raised the issue in a wide range of programs — from Medicaid and AFDC to the Highway Trust Fund. In periods when there was considerable growth in Federal spending, it was perhaps easier to accommodate the aspirations of more states; in the current era, with many parts of the Federal pie shrinking in real terms, it is not possible to insure that each state will receive funding at least equal to the prior year's level. When program changes are made in the absence of such "hold harmless" provisions, winners and losers are brought into sharp relief.

### ***Alternative Conceptions of the Federal Role***

In the extreme, a policy of complete Federal "neutrality" — defined as a balance between what each state's taxpayers pay into the Federal government, and what its citizens and firms receive in Federal expenditures — would leave very little room for a Federal role. After all, states can — and do — achieve the same result on their own. State and local taxes raised within a state's boundaries are also spent within its boundaries, and since most states operate under balanced budget requirements, these taxes and expenditures are very nearly in balance. If we adopt as a principle of Federal spending that the net flow of Federal funds to each state be zero, then the role of the Federal government would be limited to operating a unified tax system (reducing tax distortions across states) and directly determining or influencing — through restrictions and regulation — the specific activities on which

the funds are spent. At this extreme, the Federal government would amount to little more than a unified revenue-raising device.

At the other extreme, the Federal government's finances could be regarded as a tool designed to produce a redistribution of economic activity. Short of establishing interstate direct aid policies, the states by themselves would find it difficult to produce policies that systematically redistributed funds among themselves — nor would they have much individual incentive to do so. Perhaps, this line of argument would suggest, the most important thing that the Federal government can do that the states cannot naturally do by themselves is precisely to produce a net redistribution of economic activity across the states. Indeed, there is relatively little point in having a Federal fisc if we begin by assuming that it should have a zero net impact on the geography of economic activity across states — that, the states can do by themselves. The Federal government, by contrast, could be used as a mechanism explicitly for this purpose, and it occasionally has been. For example, the “revenue sharing” policies of the 1970s were based in part on state per capita incomes, and were thus explicitly designed to move funds from wealthier to poorer states.

A third conception of the Federal role is intermediate between these extremes. It suggests that the purpose of a Federal fisc is not explicitly to redistribute funds, but to conduct policies unconstrained by the financial resources of a given location. Under this view, the Federal role is to arrange for certain more or less unified services without reference to location. For the constitutional founders, these services included mainly defense and foreign affairs, but later generations have added income and health security

for the elderly and (to a lesser extent) for the indigent, access to transportation infrastructure, and environmental protection, among others. Under this interpretation of the Federal role, the *intent* is not to create redistributive Federal net flows, but one *result* may be. The animating conception is of commitments to citizens regardless of where they happen to live or the economic resources available there. Such commitments might result in significant flows of funds through the Federal government from places where resources are relatively plentiful toward places where they are relatively scarce.

The question of which interpretation of the Federal role will prevail is very much on the table in Washington today. The geographic basis of congressional representation imparts a substantial bias toward a conception of “equity” based on “neutrality,” with many representatives apparently seeking to obtain their jurisdiction’s “fair share” of the benefits of Federal spending. Indeed, instances of Federal policies explicitly designed to be redistributive across states are relatively few and far between — though instances of policies that have this effect are legion. The conception of the Federal government as a provider of unified benefits to citizens regardless of their location threatens now to break down into a program-by-program slugfest about how to insure access by each state to its “fair share” of benefits — and that generally means a share related to its associated payments to the Federal government. Thus, we see a debate about using the Highway Trust Fund as a unified revenue collection device — rebating payments to states on the basis of Federal gas tax collections within each state — rather than as a device for funding a national transportation system. If Federal commitments are thought of as

being made to people, rather than to places, this approach is at best confusing.

### **Three Myths**

The current debate is also fraught with mythology about the nature and distribution of Federal spending. Much of the public seems possessed of:

***Myth 1: Politically powerful states absorb vast amounts of Federal entitlement spending, principally for “welfare” (AFDC), and these funds dominate the geography of Federal spending.***

This myth has been propounded by some politicians as well, perhaps because, like most useful and prevalent myths, it has a grain of truth underlying it. It *is* true that the geographic distribution of Federal entitlement spending is an important overall component of the geography of Federal spending. But it is payments to the elderly, not to the poor, that make up the bulk of this spending, and which largely determine its geography. *Thus, differences across states in the age distribution of their residents are a more important determinant of their relative balance of Federal funding than are differences in their poverty rates.*

Many have noted the decline of defense spending as a component of the Federal budget and have witnessed the intense political debate produced by proposals to close and consolidate defense installations. Not surprisingly, the only politically palatable means of absorbing these spending reductions has been to spread them broadly across the geographic landscape. This has given rise to:

***Myth 2: The decline in defense spending implies that relative success in attracting or retaining military installations and other defense spending is no longer important as a determinant of the overall net flow of Federal funds to states.***

It is true that defense spending has shrunk considerably as a fraction of overall Federal spending. And it is true that the ability to attract substantial amounts of defense spending and large defense installations was traditionally an excellent predictor of where a state would stand in the overall ranking of net Federal funds flows. And it is further true that the reduction in defense spending has reduced the extent to which defense wages and salaries and defense procurement dominate the geography of Federal spending. Nonetheless, defense spending remains an important engine of that geography: a small number of states have persistently been, and continue to be, highly successful on a per capita basis in attracting defense spending, and their success in this area is a major determinant of their overall standing among states with regard to the net flow of Federal funds.

And finally, what about the other side of the ledger? Reforms of the Federal tax system in the early- and mid-1980s decreased average Federal income tax rates, and fostered:

***Myth 3: The general flattening of tax rates has reduced the disparities in Federal tax collections among states, reducing the impact of taxes as a determinant of the overall balance of payments outcomes for states.***

While average tax rates have indeed fallen, the *progressivity* of the Federal income tax — at least when viewed across states arrayed in order of their per capita incomes — has actually increased. Moreover, the dispersion of per capita incomes across states has increased. The result is that per capita tax collections continue to vary widely among states, and remain an important engine of overall locations in the distribu-

tion of states in terms of their balance of payments. Because of the close link between income and Federal taxes, this implies that state per capita income is by itself one of the most important single determinants of overall standing in the distribution of balance of payments. This creates a strong systematic bias toward having a balance of payments surplus with the Federal government in less wealthy states and toward having a balance of payments deficit with the Federal government in wealthier states.

### ***Beyond the Myths: Constructing a More Informative Analysis***

What is perhaps most confusing to those who think there is a role for redistribution among states by the Federal government — either as an explicit policy by itself or as a by-product of policies chosen for other reasons — is the devolution of the debate about the “fairness” of Federal spending policies into a program-by-program examination. The “fairness” of the geographic impact of Federal spending is surely an important and appropriate topic — but not much can be said about the overall fairness of the geography of Federal impacts by examining each program by itself. Geographic fairness is a forest-level issue, and it cannot be assessed accurately from tree-level views.

As the debate has focussed on the issues of each program by itself, some of the realities of the overall picture of the geographic impact of Federal activity have become lost. In this report, we step back from the distribution — and from the politics — of each underlying program and look instead at the geography of the approximately \$1.2 trillion of domestic taxing and spending that the Federal government undertakes each year.

To develop such an analysis, we need to obtain geographic data on Federal tax col-

lections and on the location of Federal expenditures, and we need to specify a series of definitions, conventions, and concepts that make precise what we will mean by the flows of Federal funds in and out of states and how we will measure and interpret them.

Appendix A details the sources of our data. The National Tax Foundation annually presents estimates of Federal tax collections by state, and these estimates underlie our analysis of the geography of Federal taxes. The Bureau of the Census provides reasonably consistent historical geographic data on Federal expenditures; these figures provide the basis for our analysis of expenditures.

Appendix B lays out in detail the concepts and methodology we have developed and applied. For purposes of the analysis presented here, we exclude those aspects of Federal spending that do not occur domestically (for example, defense expenditures made in other countries), or for which we cannot get geographic data on the recipient distribution (most importantly, interest payments on the Federal debt). So as not to treat the Federal deficit as a free source of resources (each dollar of debt, and the interest on it, is eventually paid — even if only by issuing additional debt), we distribute an amount of taxes equal to the total amount of domestic spending for which we can get geographic allocation information.<sup>1</sup> Throughout the report, we adjust figures for taxes and spending to account for differences in costs of living in different states. These indices are listed in Table C-2 of Appendix C. Thus, we are examining the flows of “purchasing power” that result from Federal activity.

*The difference between Federal spending received and taxes paid is the “balance of payments” between each state and the Federal government.* A negative balance of

1. We refer to this approach as a “balanced-budget” approach to examining the geography of Federal spending. We are thus focussing on the question, *What is the net geographic impact of Federal spending on allocable, domestic Federal programs, together with the tax collections necessary to fund those expenditures?*

payments indicates that the state is a net donor — it pays more in Federal taxes than it receives in Federal spending. Conversely, a positive balance of payments indicates that a state receives more from Federal spending than it pays in Federal taxes. These states experience a net gain in economic activity as a result of Federal policies and might be described as recipients.

In a system where Federal policies are either explicitly designed to redistribute eco-

nomics activity across states, or where commitments are made without reference to geography, there will always be donor and recipient states. We have no presumption that the net flow of economic activity is either desirable or undesirable. We seek simply to present what the different outcomes are and to understand how they come about — that is, to explain the major forces that drive the differences in outcomes across states.

## B. The Balance of Payments in FY 1995

One might expect to see the balance of payments near zero for most states, but the distribution is actually quite wide. Table 3 presents the balance of payments per capita and in total for each state and its corresponding rank among the states. (A rank of 1 indicates a large balance of payments surplus.) Nine states experienced balance of payments deficits of more than \$1,000 per capita in 1995, and 16 states had surpluses of more than \$1,000, so fully half of all states had Federal taxes and spending unbalanced by more than 20 percent of the average inflow (approximately \$5,000 per capita). About one third of the states had relatively modest surpluses or deficits of between -\$500 and +\$500 per capita.

Thus, there are many states for which Federal financial flows create a significant transfer of economic activity. The map in

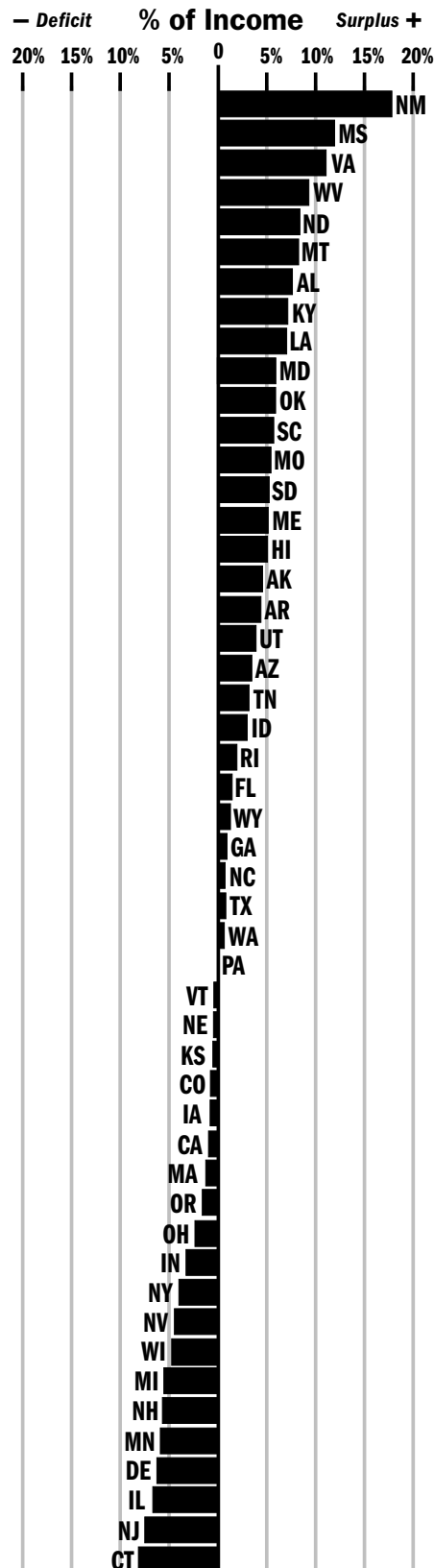
**Table 3: Balance of Payments, FY 1995**

State	Per Capita	Rank	Total (in millions)	State	Per Capita	Rank	Total (in millions)
AL	\$1,514	9	\$6,437	NE	-\$42	33	-\$69
AK	1,005	16	607	NV	-1,106	44	-1,692
AZ	763	20	3,217	NH	-1,286	45	-1,476
AR	886	19	2,201	NJ	-1,883	50	-14,959
CA	-197	37	-6,225	NM	3,300	2	5,560
CO	-127	35	-475	NY	-978	42	-17,734
CT	-2,099	51	-6,873	NC	70	28	507
DE	-1,408	48	-1,010	ND	1,661	6	1,065
FL	357	25	5,058	OH	-525	40	-5,855
GA	124	27	895	OK	1,116	14	3,660
HI	969	18	1,151	OR	-342	39	-1,074
ID	580	23	675	PA	11	31	127
IL	-1,595	49	-18,875	RI	390	24	386
IN	-710	41	-4,122	SC	1,146	13	4,209
IA	-148	36	-421	SD	1,097	15	799
KS	-59	34	-152	TN	710	22	3,734
KY	1,378	10	5,318	TX	61	29	1,151
LA	1,352	11	5,869	UT	748	21	1,459
ME	1,004	17	1,245	VT	-11	32	-7
MD	1,520	8	7,665	VA	2,695	3	17,834
MA	-233	38	-1,413	WA	46	30	248
MI	-1,367	46	-13,054	WV	1,904	5	3,481
MN	-1,393	47	-6,421	WI	-1,089	43	-5,580
MS	2,216	4	5,976	WY	311	26	149
MO	1,225	12	6,525	DC	30,817	1	17,073
MT	1,584	7	\$1,378				

Figure 5 shows the geographic distribution of the balance of payments across the country, highlighting states with large balance of payments surpluses and deficits. Large balance of payments deficits are concentrated in



**Figure 6**  
**Per Capita Balance of**  
**Payments as a Percent**  
**of Per Capita Income,**  
**FY 1995**



capita Federal tax payments and per capita receipts of Federal funds are near the national average will be near the center of the chart. States with high Federal spending and low taxes will appear in the upper left-hand corner. At the opposite extreme, states with high taxes but low Federal spending are in the bottom right-hand corner.

The largest concentration of states cluster toward the center of the chart, indicating that their Federal tax and Federal spending characteristics are close to the national average. But many states are positioned far from the national average for spending or taxes and a few states have significant differences along both dimensions.

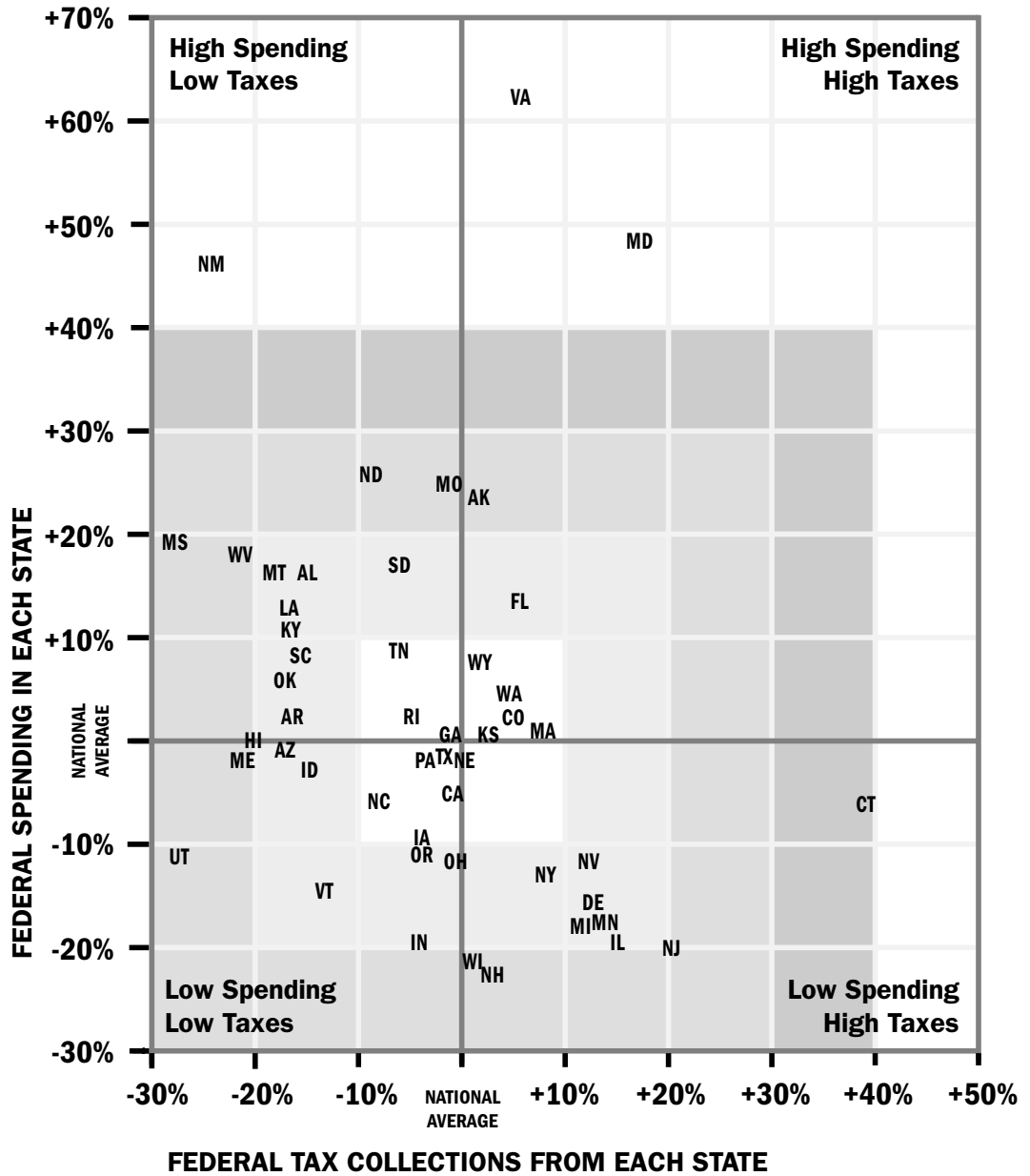
Virginia and New Mexico have very different tax burdens, yet both stand out as states that have been extremely successful in attracting Federal spending dollars. They are linked by the large amount of defense spending that takes place in each state. Virginia also benefits, of course, from its proximity to Federal activity in Washington, D.C.

At the other end of the spending spectrum, New Jersey, with high per capita income and taxes, receives comparatively little in the way of Federal expenditures. The state is not a major center of defense spending and given its low poverty rate,<sup>2</sup> it is not surprising that New Jersey does not receive a large share of the Federal money allocated for welfare programs. Moreover, the harsh northeastern winters and high cost of living in the state are unlikely to attract retirees (and their Federal benefits).

Mississippi and Utah stand out as two states with exceptionally low Federal tax burdens. They diverge, however, when we consider Federal expenditures in each state. Utah receives relatively little Federal spend-

2. Appendix C-7 lists state poverty rates using income distributions that are adjusted by states' cost of living and net income from state income transfer programs.

**Figure 7**  
**Per Capita Taxes and Spending Compared to National Averages**  
 Two states with identical balance of payments may have very different underlying situations. The graph separates the effects of taxes and spending and presents the information in comparison to the per capita national averages. The horizontal axis measures Federal tax collections from each state; the vertical axis plots Federal spending. States with high Federal spending and low taxes will appear in the upper left hand corner of the graph. States with high taxes but low Federal spending can be found diagonally across the graph in the lower right hand corner.



ing (although, with its low tax burden it is still a net recipient of Federal funds). Defense spending is average, but Utah falls far behind in funds allocated for retirement benefits and social services. To some extent this may reflect Utah's low poverty rate (49th out of the 50 states). It also reflects Utah's relatively young age distribution, which reduces its receipt (on a per capita basis) of

income security payments to the elderly. Mississippi, on the other hand, has a high poverty rate, and consequently receives much more from the Federal government to support social service programs.

### C. The Relative Importance of Taxes and Expenditures in Determin- ing States' Balances of Payments

Overall, are taxes or expenditures more important in determining the outcome of states' positions as net recipients or donors to the Federal fisc? The answer is that taxes are important, but not as important as the states' success in attracting Federal expenditures. In the aggregate, Federal tax payments vary across the states less than do expenditures. In FY 1995, the standard deviation of per capita tax payments across the states was \$640, while for expenditures it was \$855. Thus, *there is more variation induced in the overall position of states through the expenditure side than through the tax side.*

When we try to predict the balance of payments ranking of states using only their ranks in (1) overall expenditures and (2) total taxes as the predictive variables, the states' rank in expenditures turns out to receive more weight as a predictor. Interestingly, however, this turns out to be mainly because the balance of payments outcome for a few states is almost completely determined by their dramatic comparative success in attracting Federal spending — virtually independent of their tax payments. The six highest ranked states in receipt of Federal expenditures are (in order) Virginia, Maryland, New Mexico, North Dakota, Missouri, and Alaska; they average over \$1,800, or about 40 percent, more than the national average in per capita Federal expenditure receipts. They are so successful at attracting Federal expenditures that it almost doesn't matter what their taxes are — their balance of payments will be strongly positive. When those states are removed from the sample, taxes and remaining expenditures turn out to be approximately equal as predictors of states' overall position with respect to balance of payments. Thus, a significant share

of the total variation among states in per capita receipts of Federal spending is being produced by a half-dozen states that are dramatically more successful than other states in garnering Federal expenditures.

And which Federal expenditures are these states so successful in attracting? Contrary to both Myths 1 and 2, it is, in the main, defense-related spending. Five of the six states that are most successful overall in FY 1995 in attracting Federal spending have consistently been — and remain — among the top 10 states in receipt of defense spending. So while defense spending has become smaller, and may be a less important determinant for the balance of payments outcomes across all states, it nonetheless remains a nearly dispositive determinant for a small handful of highly defense-engaged states.<sup>3</sup>

If the (defense-related) success of the top half-dozen states is held aside, the success of the next handful of states — Mississippi, West Virginia, South Dakota, Alabama, Montana, and Florida — is largely generated by their comparatively high receipts of Federal payments directly to individuals — a category dominated by payments of Social Security to the elderly. The geography of this component is thus induced principally by the residential location choices of retirees.

Thus, both taxes and expenditures are important to the overall geography of Federal activity. Expenditures are the most highly variable component of the equation, and thus the best overall predictor of the outcome. Expenditures are a complicated mix of programs, however, so as a single factor, taxes are an enormously important determinant of the overall position of individual states. Federal tax payments, in turn, are strongly related to the states' per capita

3. The exception to the rule within this group is North Dakota, which is only about average in defense. It is propelled into the ranks of the leading states in overall spending by its extraordinary success at attracting Federal funds in agricultural subsidies, intergovernmental grants, and salaries and wages.

incomes — which implies that per capita income is, by itself, one of the strongest factors influencing the relative position of states with regard to their balance of payments with the Federal government. Taxes can be thought of as the “deep drumbeat” in the background, exerting a strong baseline influence on each state’s balance of payments position, systematically determined almost completely by its per capita income. The rest will be determined by the states’ success at attracting various forms of Federal spending. And if taxes are the deep drumbeat in the background, then the loudest notes in the foreground are being sounded by defense spending and income transfer programs (mainly to the elderly).

The facts are thus at odds with major parts of all three myths. Myth 1 propounds

the idea that federally legislated and financed income transfer programs have an important impact on the geography of the overall flow of Federal funds. But this effect is substantially smaller than commonly supposed — defense spending and taxes are more powerful forces — and it is not “welfare,” but the non-means-tested income transfer to the elderly through social security that is the main engine of this influence. And while, as Myth 2 asserts, the effects of defense spending as a geographic influence have been attenuated by the decline in the defense budget, it remains a singularly determinative force for a small collection of states. Finally, Myth 3 greatly exaggerates the effects of tax reform — taxes remain an important force, creating major differences across states in the point of departure from which their balance of payments will be determined.

#### **D. Tax Payments: Causes and Effects**

**T**here are important differences across states both in the taxes they pay and in the Federal spending they receive, but *it is much easier to predict the tax side of the balance of payments equation than the spending side.* Figure 8 shows the geographic distribution of per capita Federal tax payments (adjusted by state cost of living indices). There is no immediately obvious pattern to this geography.

By and large, it is the wealthier states that pay higher than average taxes. Nearly all Federal tax payments are directly linked either to wages or to income — personal and corporate income taxes, Social Security and Medicare taxes are all tied to components of the income stream earned by taxpayers. It

should therefore be no surprise that the Federal taxes collected from each state are strongly correlated with per capita income. The relationship between the states’ per capita incomes and their Federal tax payments is, in statistical terms, unusually strong: it has a correlation coefficient over .95. The most important determinant of a state’s Federal tax payments — far ahead of any other influence — is the income earned by its residents.

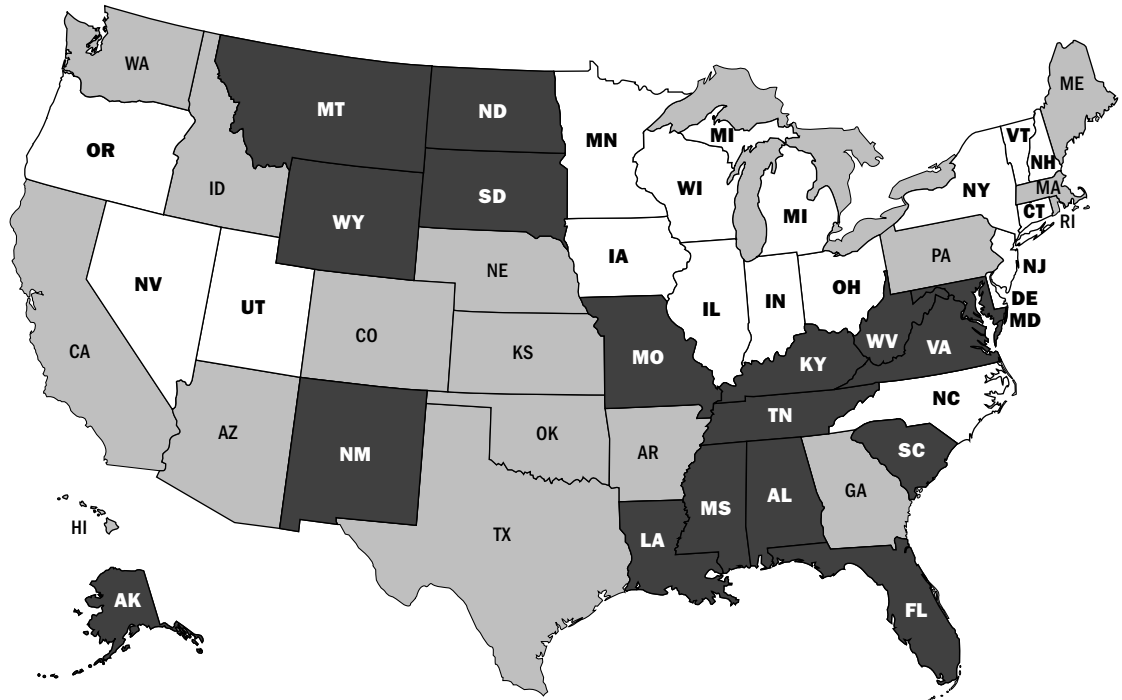
And how much do taxes rise with income? In 1995, the tax system, as viewed across states, was moderately progressive. States with higher per capita incomes paid more in Federal taxes by about 30 cents on average for each additional dollar of income.



**Figure 9**  
**Per Capita Federal**  
**Spending, Fiscal Year**  
**1995**

**KEY**

- Lowest amount of Federal monies received (\$3,640 – \$4,500)
- Moderate amount of Federal Spending (\$4,500 – \$5,100)
- Highest amount of Federal monies received (\$5,100 – \$7,780)



**E.**  
**Total Federal**  
**Outlays**  
**Allocated**  
**by State:**  
**A Comprehensive**  
**Look**  
**by Object of**  
**Expenditure.**<sup>4</sup>

4. "Object of expenditure" is a term used by accountants to categorize what was purchased as a result of a transaction (e.g., salaries and wages vs. goods and services). The Census collects data on the geography of Federal spending organized first by object of expenditure, secondarily by agency (education, defense, and so on), and then by detailed program. This makes it difficult to construct reliable data on overall programs (like entitlements or law enforcement), which may be spread over multiple agencies. As a result, our detailed examination of the distribution of components of spending is organized by objects of expenditure.

**F**igure 9 shows the state distribution of Federal expenditures in FY 1995, adjusted for the states' different costs of living. The composition of Federal outlays plays an important role in determining which states are more or less favored in receiving Federal outlays. The five major objects of Federal expenditure tracked geographically by the Census are (in order of size): (1) payments to individuals; (2) grants to state and local governments; (3) procurement; (4) salaries and wages; and (5) other allocable expenditures. The order of importance of these components to the states' balance of payments positions is different, however. As we shall see below, procurement and salaries and wages, which are primarily related to defense, have historically been the most important components of Federal spending. Even though it represents 46 per-

cent of the Federal budget, payments to individuals follows (defense-dominated) procurement and salaries and wages in explaining total Federal spending.

Why should an area of spending like procurement that accounts for only 13 percent of total Federal outlays serve to explain whether a state is more or less favored by total Federal spending? The reason is that those states that receive more than average Federal procurement receive *much more* than average, and those states that ranked at the bottom of procurement and salaries receive *much less* than average. By contrast, those receiving more in direct payments to individuals or grants to state and local governments are not very far from the average. So, while the average state receives less than \$650 per resident in procurement, the twelve most favored states receive over \$400

more per capita; while the difference from the average direct payments to individuals for the top 12 states is only \$200 on a base of more than \$2,600. Table 4 below shows the difference from the mean for the top and bottom twelve states in the five categories of spending.

**Table 4: FY 1995 Spending, National Average vs. Selected States**

(Per Capita Figures)	Average of All States	Top 12 States Different from Average	Bottom 12 States Different from Average
<b>Expenditures</b>	<b>\$4,895</b>	<b>\$1,176</b>	<b>-\$941</b>
<b>Procurement</b>	<b>634</b>	<b>417</b>	<b>-306</b>
<b>Salaries/Wages</b>	<b>516</b>	<b>309</b>	<b>-279</b>
<b>Payments to Individuals</b>	<b>2,625</b>	<b>202</b>	<b>-184</b>
<b>Grants</b>	<b>908</b>	<b>128</b>	<b>-100</b>
<b>Other</b>	<b>212</b>	<b>120</b>	<b>-73</b>

Note: These statistics are averages of the per capita spending figures adjusted for costs. Because the District of Columbia is such an outlier, it has been excluded in the calculation of the averages.

The explanatory power of entitlements, however, becomes substantially more important if we exclude the states whose real procurement receipts are extremely high — Virginia, New Mexico, Maryland, and Missouri. The remaining top eight states averaged \$270 per capita more in payments to individuals compared to \$60 per capita less in procurement than the average state.

### **1. Procurement: Direct Purchases of Goods and Services.**

Direct purchases of goods and services have historically contributed more to regional balances of payment disparities than any other part of the budget — and they continued as the most powerful single influence in FY 1995. Direct Federal purchases are dominated by expenditures for defense and the development of natural resources and public infrastructure.<sup>5</sup> Although the geographic distribution of many Federal purchases, especially major defense procurements, reflects the outcome of a competitive bid-

ding process, a large fraction of procurement expenditures are directed to specific locations at the discretion of the Executive Branch. Procurement (net of the U.S. Postal Service) represented 13 percent of total FY 1995 expenditures.

Historically, the South, West and New England have been major beneficiaries of Federal procurement policies, and that pattern continued in FY 1995.<sup>6</sup> Not surprisingly, due to their proximity to the nation's capital, Virginia and Maryland ranked second (after the District of Columbia) and fourth in their receipts of Federal procurement dollars per capita. New Mexico's nuclear labs also consistently draw among the highest levels of Federal procurement. Defense expenditures account for two-thirds of procurement outlays overall and, with few exceptions, the states ranking highly in procurement all received high levels of Defense Department spending.

Surprisingly, even though "payments to individuals" is the largest component of Federal expenditures, the level of Federal procurement per capita remains a better predictor of those states that are likely to be more or less favored by Federal outlays overall. Six of the ten states with the highest receipts of Federal outlays per capita also ranked in the top fifteen states in terms of Federal procurement per capita. Conversely, seven of the ten states with the lowest total outlays per capita also ranked in the bottom ten in their receipts of procurement dollars.

### **2. Salaries and Wages.**

Federal spending for the personnel needed to administer Federal programs, distribute benefits and ensure the nation's defense fall under the category "Salaries and Wages." Approximately two million Americans are

5. While the Census includes U.S. Postal Service procurement contracts as a Federal outlay, it has been netted out of this analysis, since in FY 1995 all postal outlays were offset by postal revenues and were not included in the U.S. Budget calculation of total Federal expenditures.

6. Per capita values and state rankings for this and the other object-of-expenditure components of Federal spending are presented in Appendix C-4.

directly on the Federal payroll, exclusive of the U.S. Postal Service. Their salaries and wages accounted for 8 percent of FY 1995 Federal expenditures. The Department of Defense accounted for about 55 percent of spending on salaries and wages in 1995. As a consequence, states with large defense installations, such as the Pacific and South Atlantic states, received a disproportionate share of such outlays.

Not surprisingly, the nation's capital ranked first in Federal salaries, receiving \$19,000 per capita.<sup>7</sup> Notably, the four highest ranked states — Virginia, Alaska, Hawaii and Maryland — received an average of \$1,530 per capita in Federal salaries, while the other 46 states averaged \$430 per capita.

Salaries is another area of spending in which favored states are highly favored. The twelve states receiving the most Federal spending per capita received on average \$310 more in salaries and wages than the \$515 received by the average state.

### **3. Payments to Individuals.**

While defense spending explains the success of the six states ranked at the top in terms of overall receipts of Federal funds, payments to individuals is a defining factor for the next six states. Mississippi, West Virginia, South Dakota, Alabama, and Florida are in the top quartile of payments to individuals; Montana ranks seventeenth.

Payments to individuals include direct Federal transfer payments such as Social Security (\$328 billion), Medicare (\$157 billion),<sup>8</sup> Federal retirement and disability payments (\$67 billion), Supplemental Security Income (SSI) (\$25 billion), Food Stamps (\$23 billion) and Veterans benefits (\$19 billion). Our largest income transfer programs, they offer benefits to the elderly and are entitlement

programs with benefits available to all persons defined as eligible under the authorizing legislation. For these programs, the regional allocation of transfer payments depends primarily on the geographic distribution of persons who qualify to receive them.

Payments to individuals comprised 46 percent of all Federal expenditures in FY 1995. Some of these payments, like Social Security, unemployment compensation and food stamps, generally reinforce the effects of the progressive income tax system by redistributing wealth from the relatively well-off to the relatively poor. Others, like Medicare and Federal retirement and disability payments, apply to people across the economic spectrum.

The District of Columbia ranks first in this category, receiving in FY 1995 more than \$5,200 per capita.<sup>9</sup> Although it receives slightly less than average Social Security payments, its Federal retirement and Medicare payments per capita are the highest in the country. Florida, with a large elderly population, consistently ranks second in per capita distribution of payments to individuals. West Virginia ranks third in direct payments to individuals primarily due to its high receipts of Social Security payments to survivors and the disabled. West Virginia residents also ranked fourth both in their receipts of Food Stamp payments and Supplementary Security Insurance. With one of the lowest costs of living in the country, West Virginia's Federal payments go further than a state like Pennsylvania, which also receives high nominal payments.

The cost of living adjustments are an important factor in the rankings of states' payments to individuals. The Northeastern states, which have traditionally ranked high in this category because of high nominal per

7. Per capita values and state rankings for this and the other object-of-expenditure components of Federal spending are presented in Appendix C-4.

8. Since the Census reports gross Medicare obligations rather than actual expenditures net premiums (which is the figure published in the Budget of the U.S. Government), "payments to individuals" has been adjusted by replacing the Medicare obligations figure by actual expenditures as reported by the Health Care Finance Administration. Medicare premiums are then deducted proportionally from each state based on the distribution of actual Medicare outlays. The Budget also reports net Pension Guarantee Insurance payments, so we have subtracted them from "payments to individuals" as well.

9. Per capita values and state rankings for this and the other object-of-expenditure components of Federal spending are presented in Appendix C-4.

capita Social Security retirement, Medicare and unemployment compensation payments, in real terms are among the lowest recipients. Because of their low costs of living, the average or even slightly below average nominal payments in the Plains, East South Central and West South Central states (excluding Minnesota and Texas) have a greater impact.

#### **4. Grants to State and Local Governments.**

Although successfully attracting grants to state and local governments is not, by itself, enough to propel a state into a high ranking of Federal spending overall, it is nonetheless an important additional component for many high ranking states. The largest programs financed by intergovernmental grants are health care for the poor, or Medicaid (\$89 billion), transportation (\$26 billion), urban development (\$25 billion), Aid to Families with Dependent Children, or AFDC (\$17 billion) and education (\$16 billion). Like many of the programs under “payments to individuals,” “grants to state and local governments” include cash assistance and entitlement programs. Since state and local governments may determine eligibility criteria and benefit levels for many of these programs, state disparities are often explained by state programmatic priorities and ability to finance the matching requirements of Federal grant programs. Grants continued its growth as a share of the budget, accounting for 15 percent of Federal spending, and for the third time in eleven years represented more Federal spending than did procurement in FY 1995.

Primarily because of high Medicaid payments, housing and Metro subsidies, and a separate District of Columbia subsidy, the country’s capital has ranked first in receipts of grants to state and local governments for

the past decade.<sup>10</sup> Eleven of the top ranked states consistently ranked in the top fifteen over the course of the past decade. New York, West Virginia and Rhode Island’s Medicaid programs alone make up half or nearly half of their Federal grant receipts, ensuring consistent high rankings for these states. States like Alaska, Montana, Wyoming and New Mexico also take advantage of the Department of Transportation programs and Minerals Management funds to maintain their high rankings.

Louisiana, ranking 29th in FY 1985, consistently increased its share, so that by FY 1992 it was fourth of all states, a position it has retained in FY 1995. In FY 1995, a large block of South Central states also received a larger than average share of Federal grants to state and local governments. Interestingly, Virginia and Maryland, which receive much higher than average Federal procurement per capita, and Florida, which receives such a substantial amount of payments to individuals, were far below average in their receipt of grants to state and local governments.

#### **5. Other Allocable Programs**

A small proportion of Federal expenditures are for programs, such as grants to non-governmental recipients for health and basic scientific research (\$21 billion), for Federal employees’ health and life insurance programs (\$10 billion) and for Department of Agriculture crop stabilization and disaster assistance programs (\$8 billion), that are allocable by state. These accounted for 3 percent of all Federal spending in FY 1995. After the District of Columbia, North Dakota is the highest ranking recipient of these programs, which accounted for 20 percent of all Federal spending in that state<sup>11</sup>.

10, 11. Per capita values and state rankings for this and the other object-of-expenditure components of Federal spending are presented in Appendix C-4.

## F. Historical Trends in Per Capita Balance of Payments

In our earlier analysis, we observed that a state's per capita balance of payments position was driven by four engines: 1) the overall economic activity in the state which determines the level of Federal taxes paid; 2) whether it is a locus of defense spending; 3) the demographics of the state — particularly the proportion of elderly, disabled and poor — which results in larger than average entitlement spending; and, to a lesser extent, 4) the states' social policies and willingness to finance the matching requirements of Federal grant programs. Changes in Federal policy with respect to taxes, defense spending, entitlement programs and Federal/state fiscal relationships will thus disproportionately affect the states' balance of payments to the extent to which they rely on any one of these engines.

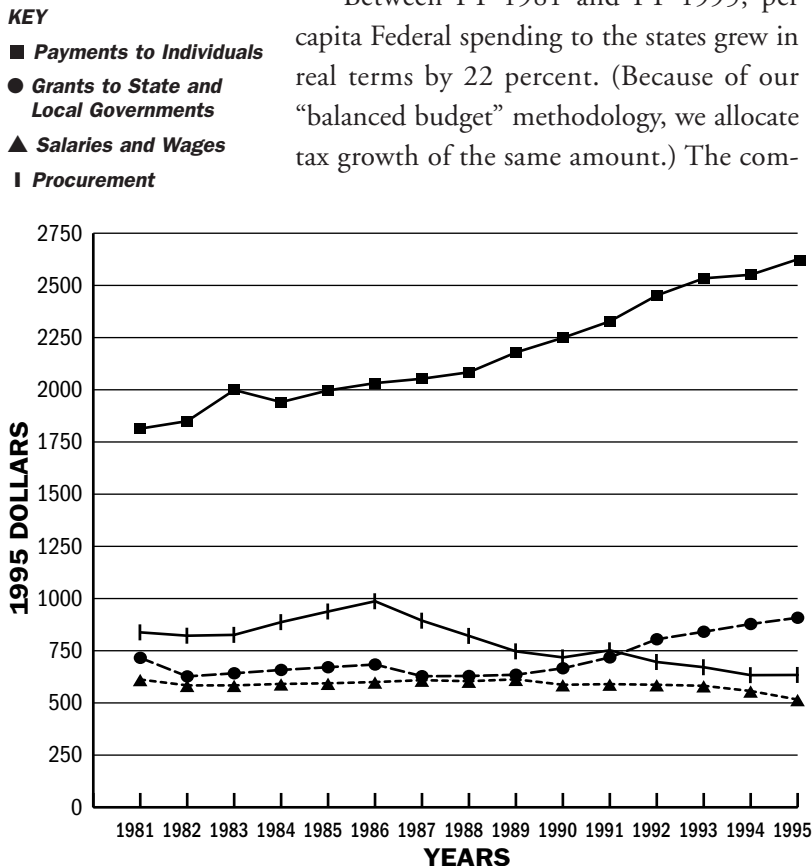
Between FY 1981 and FY 1995, per capita Federal spending to the states grew in real terms by 22 percent. (Because of our “balanced budget” methodology, we allocate tax growth of the same amount.) The com-

ponents of spending, however, have changed in dramatically different ways, as illustrated in *Figure 10*. The cuts in defense spending and the downsizing of government begun in the mid 1980s have translated to a drop in procurement spending of 24 percent followed by a decline in Federal salaries and wages of 16 percent. Entitlement programs have continued their steady increase as evidenced by a 45 percent and 27 percent growth in payments to individuals and inter-governmental grants, respectively.

Over time, then, the relative importance of taxes and the different components of spending — what we call the *share* of Federal programs — has changed. In addition, the *geography* of those programs has changed over time. How much has the overall evolution of the states' balance of payments been driven by the changing shares of Federal programs, and how much by the changes in the geography of the individual programs? In other words, have the distributions of each component of Federal spending stayed relatively constant, with changes in the states' balance of payments driven mainly by changes in the share, and the fact that different components have different geography? Or has the geography of the programs themselves changed significantly? For example, do the states that receive higher than average Federal wage payments in one year tend to be the same as those in the next year, or is there a rapid flux in the relative success of different states with regard to Federal spending?

To compare the amount of geographic change over time in different components of taxes and spending, we formed an index measuring the amount of change in the geographic distribution of each component. The fact that there is geographic variation in a

**Figure 10**  
Average Spending Per Capita, FY 1981–1995



program implies that different states have different average levels of Federal receipt or expenditure. If the geographic pattern for a given component is stable over time, then in each year each state would depart from the national average in the same way. If, for example, Missouri were found to receive Federal procurement funding of \$800 per capita more than the national average (as it did in 1995), then if the geographic pattern of procurement expenditures were highly stable, we would expect to see Missouri's receipt of Federal procurement funds be about \$800 per capita more than the national average in every year. By contrast, if the geographic distribution of procurement is rapidly changing, then a state might receive procurement funds of \$1,000 more than the national average in one year and of \$500 less than the national average in

**Table 5: Relative Geographic Volatility<sup>12</sup> of Tax and Spending Components, FY 1981-1995**

(Average year-to-year change in the state deviations from the national average, for per capita taxes and spending components)

	<b>Relative Geographic Volatility</b>
<b>Federal Taxes</b>	<b>181</b>
<b>Total Federal Spending</b>	<b>305</b>
<b>Procurement</b>	<b>213</b>
<b>Wages</b>	<b>66</b>
<b>Grants</b>	<b>63</b>
<b>Payments to Individuals</b>	<b>84</b>
<b>Defense</b>	<b>189</b>

another. (Note that by focussing on the difference between a state's receipts and the national average, we isolate the changes in the geographic pattern from those produced by shifts in the national average of spending in that component.) Applying this concept, we formed an index of the *relative* volatility of the geography of each component. The index is based on how much the average state's difference from the national average in a given component area shifted in the average year over the fifteen year sample period 1981 to 1995.

Table 5 shows the results. The geography of expenditures turns out to be more volatile than that of taxes. The year-to-year changes

in the relative success of states in attracting Federal expenditures is about 50 percent greater than the variability of the geography of tax payments. Thus, viewed across the fifteen years of our sample, the states' balance of payments positions have changed much more as a result of changes in their relative standing on the expenditure side than because of changes in the geographic pattern of taxes. Taxes, while an important component, have been relatively more stable, and thus have contributed less to determining the *changes* in the relative standing of states in the distribution of balance of payments.

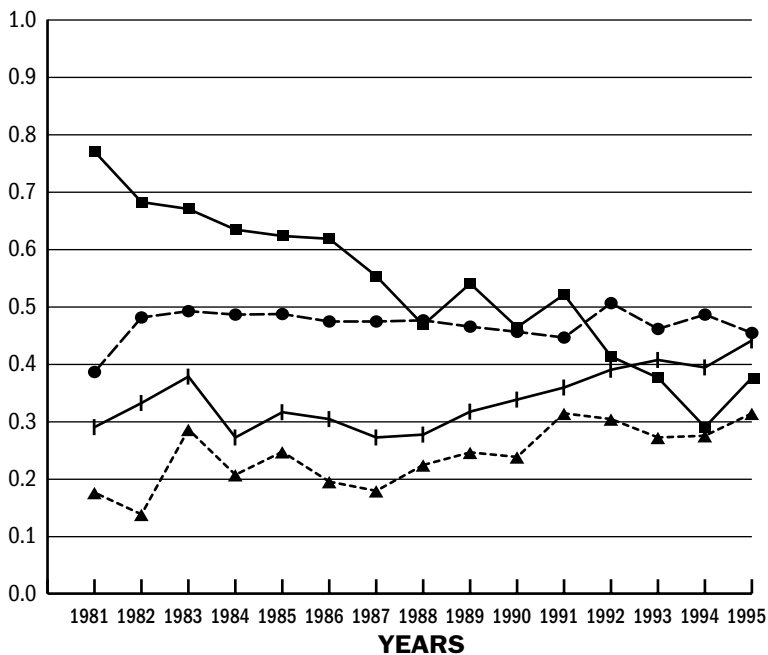
Not all components of expenditures have been equally volatile, however. There is relatively little volatility across time in the geographic distribution of either grants to state and local governments, Federal wage payments or payments to individuals. These components can be important engines for changing the outcomes for states, but largely through shifts in the share among them, rather than from changes in their own geographic distribution of benefits. By contrast, spending on procurement has been quite volatile geographically over the fifteen year period. Procurement spending by itself has changed more than the geography of taxes, even though procurement is less than one-fifth the size of taxes. Changes in the geographic distribution of procurement have accounted for about two-thirds of all the geographic volatility of total expenditures, even though procurement has generally been less than 20 percent of expenditures.

Interestingly, defense spending in total — which is principally a combination of part of procurement spending and part of Federal wages and salaries — has been somewhat less geographically volatile than procurement by itself. This suggests that one of

12. The geographic volatility statistic is a constructed standard deviation. The components of Federal spending should not add to the total. See Appendix B for methodology.

**Figure 11**  
**Weights of Spending Component Rankings as Determinants of Total Spending Ranking, FY 1981–1995**

**KEY**  
 ■ Procurement  
 ● Wages  
 | Payments to Individuals  
 ▲ Grants to State and Local Governments



the major engines of geographic change in the location of net Federal activity has been changes in the distribution of procurement for defense. The wages and salaries component of defense spending has been much more stable. And, as we saw earlier, a small group of states that are highly successful in attracting defense activities have not experienced changes in their standing as centers of defense activity, and as a result have remained near the top of the list of states

ordered by their total receipts of Federal funds. By contrast, several states — most notably California and Connecticut — that had traditionally attracted relatively high amounts of per capita Federal defense-related funding saw their success in this area decline substantially over the period we are examining — and experienced notable declines in their balance of payments as a result.

Once again, these facts belie the myth that defense spending has become less

important in determining the net geographic impact of Federal activity. For several states with very high balance of payments surpluses, it is a defining component of their standing. For several other states that were once among the main centers of Federal defense activity, changes in their overall balances of payments position have mirrored the decline in their success at attracting Federal defense funding. As defense has declined as a fraction of the budget, the geographic changes that have resulted have been enormously important for some states.

The change in relative shares of Federal spending has resulted in a shifting downward of the importance in procurement spending — and defense — as the main explanatory component of Federal spending. This should not surprise us, given its shrinking size, but its geographic distribution has also shifted, becoming less concentrated.

To see which spending components have the most explanatory influence, we calculated what weighted combination of the “spending components ranks” best predicts the “overall spending rank.” *Figure 11* shows a graph of the relative weights received by the different components of spending as predictors of the overall spending rank across time.<sup>13</sup> From once having had a relative weighting of .77 as a determinant of the spending rankings in FY 1981, procurement now has a weight of only .38, while payments to individuals and salaries and wages now explain a larger share of the outcome, with weights of .44 and .45, respectively. Thus, procurement is a substantially less prominent determinant of success in the balance of payments story than it used to be. Nonetheless, for a small number of states, it remains enormously important.

13. The weights are the regression coefficients of equations in which the dependent variable is the states' ranks in order of highest to lowest spending and the independent variables are the states' rankings of the five components of spending (procurement, wages, intergovernmental grants, payments to individuals, and other). A separate regression was run for each year.

The influence of taxes appear to have declined over the period as well, indicating that per capita incomes are becoming overshadowed by the states' differential success in attracting various components of spending.

### Results by Region and by State

So far, our analysis has focussed on the variation in the share and geography of Federal taxes and spending for the states in the aggregate, but each state also has its own individual story, and it is to these individual stories that we now turn. In prior years, we have

noted the relative stability in the rankings of states and regions over time. When we extended the analysis to cover the fifteen year period from FY 1981 through FY 1995, however, we discovered somewhat more variability. Half of the states experienced substantial balance of payments shifts over this period, compared to just the eighteen that we highlighted last year.<sup>14</sup> Seven of these experienced gains in their balance of payments conditions, eight experienced losses, and ten experienced some combination of the two. A history of the rankings of all fifty states by region is

**Table 6: Per Capita Balance of Payments, Rankings of the States, FY 1981-1995**

Region	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<i>New England</i>															
*CT	26	15	34	29	36	44	46	46	46	49	48	49	50	51	51
*ME	10	6	13	13	9	20	17	29	29	24	22	9	11	15	17
*MA	20	19	23	22	24	25	27	37	32	32	31	35	33	36	38
*NH	35	29	29	31	39	47	47	49	49	48	47	47	47	47	45
RI	23	26	27	28	29	34	33	32	34	30	26	25	26	26	24
*VT	24	23	25	26	27	35	39	41	39	42	43	40	38	39	32
<i>Mideast</i>															
DE	40	38	47	47	48	49	48	47	50	50	50	50	49	49	48
DC	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
MD	8	8	6	7	6	11	7	12	14	14	12	10	10	8	8
NJ	48	49	51	51	51	51	51	51	51	51	51	51	51	50	50
NY	39	36	37	38	42	45	45	45	45	45	45	43	43	44	42
PA	37	32	31	35	34	36	36	34	36	36	37	32	34	35	31
<i>Great Lakes</i>															
IL	51	51	49	50	50	50	50	50	48	47	49	48	48	48	49
IN	47	45	43	39	40	41	41	43	43	39	39	41	40	41	41
MI	50	47	46	48	49	48	49	48	47	46	46	45	46	45	46
OH	46	42	39	44	44	40	42	39	37	38	36	38	41	40	40
WI	45	43	44	45	46	43	44	44	44	43	44	44	44	43	43
<i>Plains</i>															
*IA	49	48	41	46	43	32	28	24	27	29	35	34	32	28	36
*KS	41	28	30	23	20	23	25	28	28	28	29	30	30	30	34
MN	43	44	42	43	45	42	40	40	42	41	42	46	45	46	47
MO	7	5	5	5	4	9	11	13	9	10	8	19	13	11	12
*NE	42	40	28	33	30	26	23	17	24	26	27	31	28	33	33
*ND	30	37	14	16	8	4	4	5	3	5	5	5	5	5	6
SD	19	16	10	10	10	7	6	6	4	7	10	13	14	13	15

14. A change in the BOP ranking was considered significant if the standard deviation of the state's rankings over time (FY 1981 to FY 1995) was five or above.

**Table 6: Per Capita Balance of Payments, Rankings of the States, FY 1981-1995**

<i>Region</i>	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<i>So. Atlantic</i>															
*FL	15	18	18	27	26	28	31	31	31	31	28	27	24	25	25
GA	22	22	22	24	23	27	29	35	33	35	32	26	25	24	27
NC	34	31	32	32	38	38	38	33	38	37	34	29	31	31	28
SC	12	10	11	11	15	16	18	18	16	9	11	11	15	14	13
VA	4	3	2	4	3	3	3	3	5	3	4	4	4	4	3
*WV	25	27	26	25	19	19	20	14	15	12	9	8	6	7	5
<i>E. South Central</i>															
AL	9	9	9	9	11	13	10	10	13	6	6	6	8	9	9
*KY	29	24	24	21	25	8	22	27	19	16	13	20	18	19	10
MS	6	4	4	3	7	5	5	4	6	4	3	3	3	3	4
TN	17	13	12	14	21	15	21	26	26	25	18	18	21	21	22
<i>W. South Central</i>															
AR	14	12	8	12	13	14	13	16	17	18	19	16	17	18	19
*LA	18	33	40	37	31	30	30	25	20	17	17	12	12	10	11
*OK	33	35	45	40	37	33	26	19	21	20	24	17	20	17	14
*TX	38	46	48	49	47	46	43	36	30	34	33	36	35	32	29
<i>Mountain</i>															
AZ	16	17	21	15	18	17	16	23	22	15	21	22	16	20	20
*CO	32	34	38	41	41	31	24	22	18	22	20	23	27	29	35
*ID	27	20	17	20	17	18	14	11	10	13	15	14	23	23	23
*MT	31	30	19	17	12	12	12	7	7	8	7	7	9	12	7
*NV	36	39	35	30	32	22	34	42	40	44	40	42	42	42	44
NM	2	2	3	2	2	2	2	2	2	2	2	2	2	2	2
*UT	13	11	15	8	14	10	8	8	8	11	16	21	22	22	21
*WY	11	50	50	42	35	39	32	20	23	21	25	28	29	27	26
<i>Pacific</i>															
*AK	5	14	33	34	28	24	15	15	12	19	14	15	7	6	16
*CA	28	21	20	18	22	29	35	38	41	40	41	39	36	34	37
*HI	3	7	7	6	5	6	9	9	11	23	23	24	19	16	18
OR	44	41	36	36	33	37	37	30	35	33	38	37	37	38	39
*WA	21	25	16	19	16	21	19	21	25	27	30	33	39	37	30

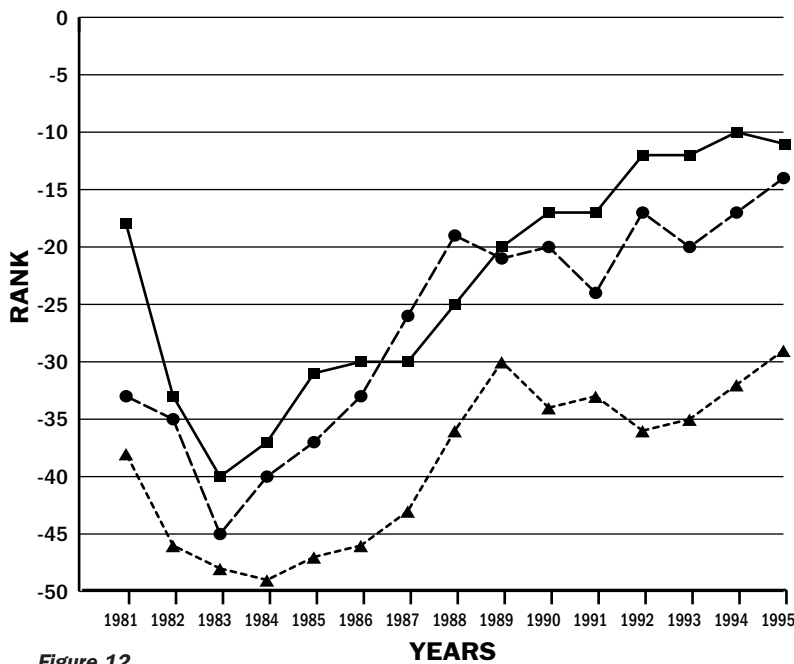
Sources: U.S. Department of Commerce, Bureau of the Census, Federal Expenditures by State for Fiscal Year 1995; Tax Foundation, Special Report "Federal Tax Burden by State," July 1996 draft.

\* Note: These rankings are based on the calculations for balance of payments using cost adjusted figures. States highlighted with an asterisk experienced a substantial change in rank over the period.

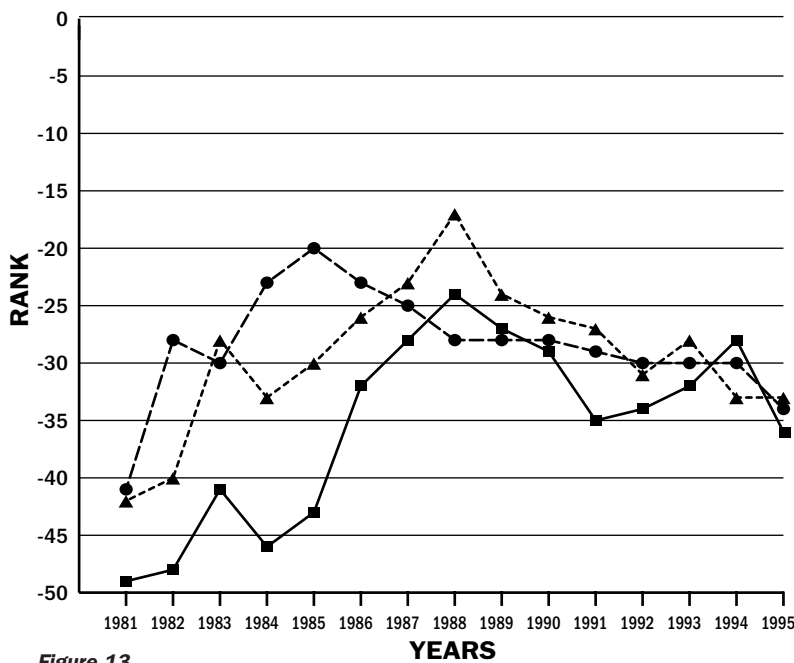
shown in Table 6. The states that experienced substantial changes over the period are highlighted with an asterisk.

What is remarkable is the stability in the balance of payments rankings of half of the states over the fifteen year period and their

regional concentration. Wisconsin reflects the twelve states that began and ended the period with balance of payments deficits or very low surpluses. With few exceptions, these states are located in the Mideast and Great Lakes regions; they consistently pay



**Figure 12**  
**Balance of Payments Rankings,**  
**Selected Oil States**  
 ■ LA ● OK ▲ TX



**Figure 13**  
**Balance of Payments Rankings,**  
**Selected Prairie States**  
 ■ IA ● KS ▲ NE

higher than average Federal taxes and receive the least in Federal spending, primarily because little defense activity is based there. At the other end of the spectrum are those Southern states, like Alabama, that began and ended the period ranked in the top third of states and continuously ran high per capita surpluses with the Federal government, primarily because of their low tax payments. Another group of states, like Arizona, consistently ran moderate surpluses over the decade and are dispersed across the country.

While half of the states' balance of payments positions remained stable over the fifteen year period, half experienced substantial change. Texas, Louisiana and Oklahoma began the period among the states most deeply in deficit but ended it in surplus. *Figure 12* tracks their improvement over the fifteen years. Montana, West Virginia and North Dakota were moderately ranked states in FY 1981, ranking 31st, 30th and 25th, respectively, but rose into the top ten by FY 1995.

Four New England states (Connecticut, Massachusetts, New Hampshire and Vermont) and three Far Western states (California, Hawaii, and Washington) experienced significant declines in rank over the decade. California, Massachusetts, Vermont and Washington all slipped from surplus into deficit status over the period. The Plains and Mountain states were dominant among the ten states that experienced dramatic rises and falls over the period. *Figure 13* shows the balance of payments rankings for Iowa, Kansas and Nebraska. In each case, farm subsidy programs played an important role in the changes in their balance of payments positions. The changes for several other Mountain states (Colorado, Idaho, Nevada

and Wyoming) could not be attributed to any factor in particular.

Sorting out the combined influences of the changes in the relative importance of the components of spending and taxes to the changes in an individual state's balance of payments for those states which experienced substantial change is not a simple matter. Over time, different influences are at play — as we discussed above, both the shares of Federal programs and the geography of those components are shifting over time. However, consistent with our findings in the aggregate, for most of the shifting states, the variation in Federal expenditures is more important than taxes in explaining changes in their balance of payments positions. In twenty out of twenty-five cases, the shift in outlays received drove the shift in the states' balance of payments. Even for those states like Connecticut, New Hampshire, Wyoming and Texas, where changes in taxes explained more of the variance than changes in expen-

ditures, expenditures are still an important driving force.

Depending on the state, the components of Federal spending that had the most influence were either defense or payments to individuals. As it becomes a larger share of the Federal budget, payments to individuals is exerting more influence on the states' flow of funds positions. Colorado illustrates how the movement in the state's defense spending drove the pattern of its balance of payments over the fifteen year period. Conversely, Oklahoma illustrates the impact of payments to individuals on the state's balance of payments outcome.

The individual state profiles, which now follow, highlight the influences that determine a state's balance of payments position. The profiles indicate fiscal year 1995 status and changes over time, with select demographic statistics that help to explain the components of taxes and spending.