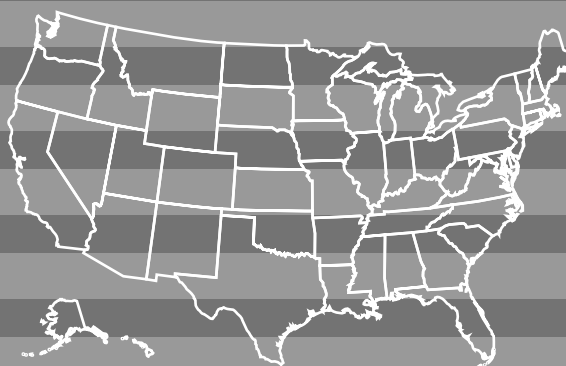


The **Federal** **Budget** and the **States**

FISCAL YEAR 1998



INTRODUCTION
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This is the twenty-third edition in an annual series of reports beginning with Fiscal Year 1976. Since 1992, the body of the report has been prepared by the Taubman Center for State and Local Government at the Kennedy School of Government at Harvard University and the introduction by Senator Daniel Patrick Moynihan.

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Marcia Ciro of Paper Trace Studio coordinated the report’s layout and graphic design, helping us to present detailed statistical information in a clear fashion.

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The Federal Budget and the States Fiscal Year 1998

Executive Summary

Figure 1

The graph to the right shows the per capita balance of payments for each state, Fiscal Year 1998.

As the nation seems to be — or at least, *hopes* to be — entering a sustained period of balanced budgets, the debate about the fairness or equity of the geographic distribution of Federal spending does not appear to be fading away. A wide disparity in the financial flows between the Federal government and each of the states has been a consistent feature of U.S. fiscal policy over the two decades captured in this report series (and probably for many years before that). While arguments are often put forth highlighting the benefits of uneven tax payments and federal spending across a diverse nation, citizens and legislators continue to raise concerns about whether states receive a “fair share” of Federal domestic spending or pay more than their “fair share” in Federal taxes.

In the day-to-day process of formulating policy and administering the government, the financial flows to and from each of the states are generally examined only in the context of individual programmatic issues. Over the past few years, bitter fights over allocation formulas dominated the legislative discussion during the overhaul of Federal social assistance programs and the reauthorization of Federal highway and transit programs. And just a few months ago, the Senate Transportation Appropriations Subcommittee approved a controversial measure that would have dismantled the hard-fought transit funding formulas established in TEA-21, the transportation bill that was enacted only a year earlier, so that more funding

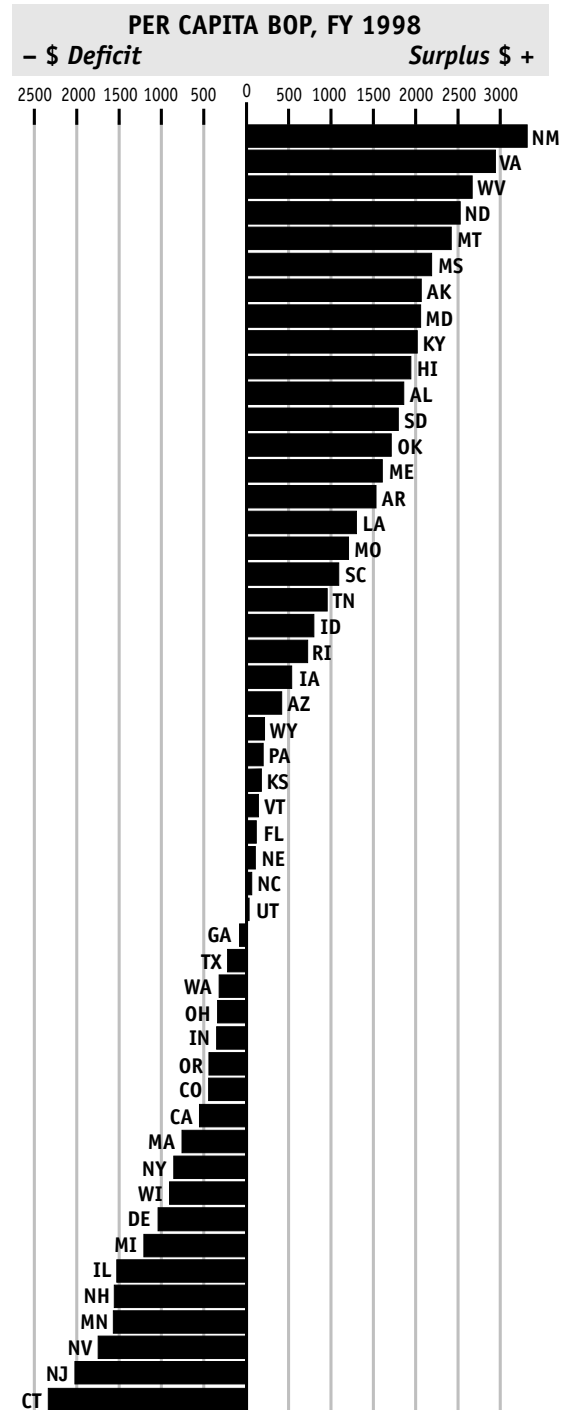
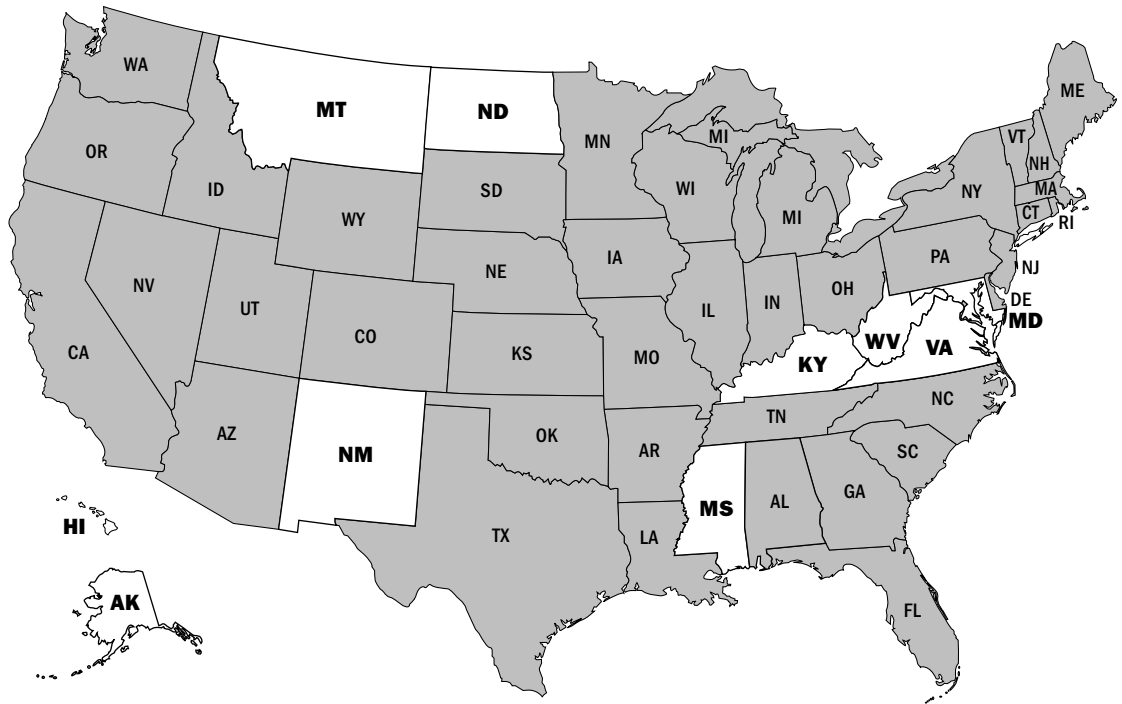


Figure 2

The ten states in white have the greatest Federal per capita surpluses.



would be available for states in the South and the West. While opponents successfully marshaled support to defeat the measure, the debate about the geographic distribution of Federal transit funding is likely to be revived in the near future.

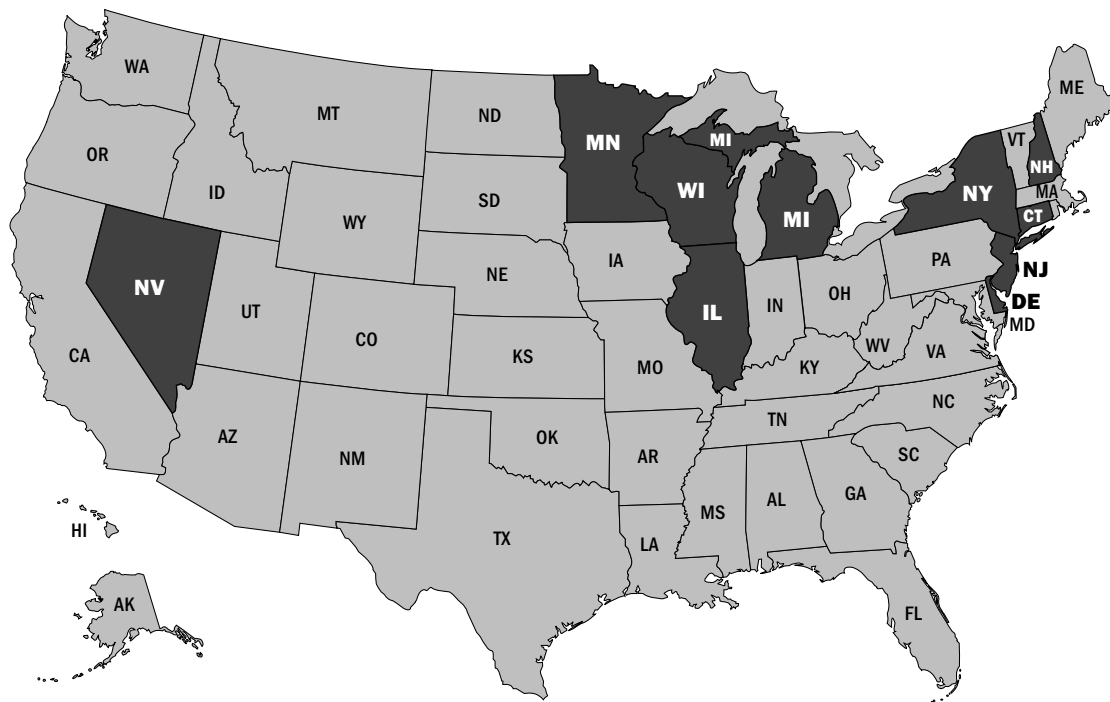
Looking beyond selected programmatic initiatives, it is no secret that the economic impacts of Federal spending and tax collections vary significantly across the states. Some states do receive considerably more in Federal spending than they pay in Federal taxes, while the tax burden for other states far exceeds the spending they receive. There is a persistent, but often misunderstood, pattern in the geography of these financial flows. In general, residents of states in the Northeast and Great Lakes regions pay much more in Federal taxes than they receive in Federal spending, while many Sunbelt and Great Plains states get more from the Federal government than they send to Washington in taxes.

Figure 1 depicts the state-specific effect of Federal spending decisions and tax collections for Fiscal Year 1998. The states at the top of the graph have a balance of payments surplus — they gain economic activity from their financial relationship with the Federal government. The donor states at the bottom pay more in Federal taxes than they receive in spending. Significant surpluses and deficits were common — fully half of the states had surpluses or deficits that exceeded \$1,100, or 20 percent of the average FY 1998 per capita Federal spending level of about \$5,300 per capita.

At one end of the spectrum, nine states had surpluses that exceeded \$2,000 per capita. While there was no obvious geographic pattern to these states, there was a noticeable concentration in just a few areas of the country (see Figure 2). New Mexico has consistently led the nation with the greatest per capita balance of payments surplus and its FY 1998 surplus of about

Figure 3

The ten states in black have the greatest Federal per capita deficits.



\$3,700 per capita was almost 30 percent greater than the surplus for Virginia, the next highest state.

Among the states with deficit flows to the U.S. treasury, Connecticut's balance of payments deficit of almost \$2,400 per capita was the largest in the nation. Connecticut residents enjoy the highest per capita income in the nation and Federal taxes collected were almost 45 percent above the national average. Seven other states, primarily located in the Northeast and Great Lakes regions, had deficits of more than \$1,000 per capita (see Figure 3).

Table 1 presents an alphabetical listing of the states with the FY 1998 per capita balance of payments and the total for each state. Ten states had total surpluses that exceeded \$5 billion, with Maryland over \$10 billion and Virginia at nearly \$20 billion. Outside of the Washington D.C. area, Kentucky and Alabama led the nation with surpluses of nearly \$8 billion. All ten of the states with

net inflows that exceeded \$5 billion were in the South and the combined surplus for these states was over \$80 billion.

California's deficit of approximately \$19 billion was the highest in the nation. This was the result of higher tax payments and lower Federal spending as the California economy improved and a statewide population that now exceeds 32 million residents, almost 12 percent of the total U.S. population. Four other states — Illinois, New Jersey, New York, and Michigan — had total deficits in excess of \$10 billion. The combined outflow from this group of five states alone was more than \$80 billion, and the total for the ten states with the largest deficits was almost \$110 billion.

The FY 1998 results continue long-standing trends. The geography of surpluses and deficits has been extremely consistent over time — the ten states with the largest per capita deficits have not changed in the past seven years and the states with the

Table 1: Balance of Payments, FY 1998

STATE	PER CAPITA	RANK	TOTAL (IN MILLIONS)	STATE	PER CAPITA	RANK	TOTAL (IN MILLIONS)
AL	1,823	11	7,932	NE	123	29	204
AK	2,108	7	1,294	NV	(1,763)	48	(3,081)
AZ	482	23	2,252	NH	(1,531)	46	(1,814)
AR	1,501	15	3,810	NJ	(2,009)	49	(16,306)
CA	(587)	39	(19,177)	NM	3,697	1	6,421
CO	(434)	38	(1,725)	NY	(835)	41	(15,183)
CT	(2,380)	50	(7,791)	NC	65	30	487
DE	(1,027)	43	(764)	ND	2,513	4	1,604
FL	125	28	1,862	OH	(361)	35	(4,046)
GA	(109)	32	(830)	OK	1,717	13	5,748
HI	1,938	10	2,312	OR	(431)	37	(1,415)
ID	799	20	982	PA	213	25	2,561
IL	(1,502)	45	(18,092)	RI	738	21	729
IN	(366)	36	(2,158)	SC	1,134	18	4,351
IA	536	22	1,534	SD	1,799	12	1,328
KS	183	26	481	TN	978	19	5,313
KY	2,029	9	7,986	TX	(247)	33	(4,879)
LA	1,283	16	5,608	UT	9	31	19
ME	1,631	14	2,030	VT	164	27	97
MD	2,101	8	10,790	VA	2,905	2	19,729
MA	(776)	40	(4,770)	WA	(348)	34	(1,978)
MI	(1,205)	44	(11,829)	WV	2,651	3	4,802
MN	(1,534)	47	(7,250)	WI	(867)	42	(4,528)
MS	2,300	6	6,330	WY	238	24	114
MO	1,242	17	6,752	DC	36,987		19,349
MT	2,401	5	2,114				

largest surpluses have changed only slightly over the same time period. Moreover, the few changes that we observe do not appear to be related directly to shifts in the priorities of U.S. domestic spending, changes in the occupancy of the White House, or the majority control of the Congress.

What Drives These Results?

By far, the most important influence determining the amount of taxes paid by a state is the average earnings of its residents. The distribution of tax burdens in FY 1998 was almost identical to the prior year, but other than the association of high average incomes with high average tax payments, there was no obvious geography to this distribution. Most regions tend to have a mixture of high- and low-taxpaying states. Northeastern states tend to have relatively high per capita incomes, and pay high Federal taxes, as do several Great

Lakes states and a cluster of states along the mid-Atlantic coast. The largest groups of low-taxpaying states are in the South and in the mountain region of the West.

Federal spending, on the other hand, is much more difficult to predict because there are many factors that influence where the Federal government spends money. No spending component can have much of an impact on very many states if it is only a tiny fraction of the total budget, and no spending component, no matter how large it may be, can have much of an impact on the results unless it varies significantly across the states. We have grouped Federal spending into five broad categories — defense (including veterans' benefits), non-defense discretionary, Social Security, Medicare, and assistance programs — and focused on the geographic distribution of each of these underlying components to understand which spending areas exert the greatest influence on the results we observe. We find that:

- The Social Security, Medicare, and assistance programs that comprise more than half of all Federal spending exhibit relatively little variation across states, and consequently are a less powerful determinant of the overall outcomes than their budget share alone would suggest;
- Defense spending, representing a much smaller portion of the Federal budget, is highly concentrated in a few states and is a more powerful determinant of the outcomes we observe; and
- Each of the spending components has a sizable range between the minimum and maximum values across the nation. Being near the top or bottom of the range in any

CRITICAL METHODOLOGICAL CONCEPTS AND CHOICES

We made the following methodological choices to define more precisely the concept of the flow of Federal funds to and from each state as that term is used in this report:

- We considered only Federal spending within the borders of the fifty states (including defense) for which the Bureau of the Census produces geographic data (the main item excluded is the interest payments on the Federal debt);
- We allocated taxes in the same amount as spending (reflecting the fact that even if there is a Federal deficit, it is not free, or if there is an overall surplus, it is not a net cost to the economy); and
- We adjusted all figures for taxes and spending to reflect the cost of living in each state.

A detailed discussion of our data sources and methodology can be found in Appendices A and B.

single category of spending is often by itself enough to have a material impact on the overall balance of payments outcome.

Redistribution Across the States

Questions about the redistributive impacts of the Federal financial system across states are persistent. While the *explicit intent* of the Federal financial system may not be to redistribute economic activity across states, it is no surprise that a net redistribution of resources and economic activity across states does occur. Our analysis shows that:

- On balance, the Federal Fisc results in a net redistribution from wealthier to less wealthy states. Both the tax side and the spending side of the financial relationship contribute to this result;
- The distribution of the tax burden across states is strongly related to per capita income, resulting in higher per capita tax payments from wealthier states. Moreover, the tax burden is mildly progressive — higher-income states pay a slightly higher *percentage* of their per capita income on taxes; and
- Federal spending varies considerably across states, with some high-income and some low-income states among the largest recipients. On average, however, higher-income states receive less Federal spending per capita than lower-income states.

Finally, the Federal Fisc is becoming more redistributive than it used to be. While the redistributive impact of the tax side has been largely constant over time, the spending side has steadily become more redistributive. We attribute this result to three factors:

1. The mix of Federal spending has changed. The fastest growing elements of the Federal budget — Social Security, Medicare, and other Federal retirement and disability programs — has always been at least mildly oriented toward lower-income states. The increasing size of these programs as a percentage of total Federal spending is a force pushing the Fisc toward a more redistributive overall outcome.
2. Federal grants to state and local governments have become more concentrated toward lower-income states. Part of this change is due to the increase in Medicaid as a component of Federal grants. And part of it is due to relative changes in individual states' economic conditions.
3. Defense spending has declined significantly in a small number of high-income states (in particular, California, Colorado, and Connecticut). The historical orientation of defense spending toward higher-income states has also been declining over time.

Notwithstanding the lack of consensus about the goals of the Federal financial system, the trend of recent years has been toward greater redistribution from wealthier states to lower-income states.

Programmatic Transfers

Looked at differently, the redistribution we observe results from a series of programs, with each state gaining funding in some program areas and losing funding in others. This year, for the first time, we look in detail at the redistribution across states generated by each major component of Federal spending. While the amount of redistribution

achieved through cross-state flows is relatively modest (less than 10% of the current amount of Federal spending), there is considerable variation in the degree to which individual programs contribute to these transfers. Our central findings are:

- The programs that are most directly designed to produce income redistribution across *individuals*, which we refer to collectively as assistance programs, generate the smallest transfers across *states* (in absolute terms, and relative to their size as a component of the budget). In effect, the nation's direct income support and related benefits programs are, for all practical purposes, funded in most states by the taxpayers of the same state;
- The Social Security and Medicare programs generate net transfers of about \$50 billion — a modest amount, given the widely held belief that these programs transfer income and services to relatively less-affluent people, and given the more than \$600 billion in total that is spent on these programs; and
- Defense spending generates, for its size, considerably more net transfers across states than any other program, amounting to about \$60 billion in transfers from spending of only about \$230 billion. This results from the concentration of defense spending in a small number of states, creating a large collection of donor states.

State Profiles

Throughout this report we focus on the factors that are helpful in understanding the national trends and patterns in the geographic distribution of taxes and spending. Still, the circumstances particular to an individual state are often an important factor in understanding the balance of payments outcomes.

The *State Profiles* that follow this report capture state-specific information and highlight the different factors relevant for each state. Each profile includes demographic information that helps to understand the distribution of the parts of Federal spending that are largely determined by characteristics of the population. We rank each state according to the overall balance of payments and also in relation to the separate tax and spending data. As a new feature of this report, each *State Profile* highlights the distribution of Federal spending by program — defense, non-defense discretionary, Social Security Medicare, and assistance programs — instead of by the “objects of expenditure” that we have used in prior reports in this series. State-specific calculations for the balance of payments, taxes, and spending by program can be compared to national averages. And the historical trends in taxes and spending (adjusted to 1998 dollars) allow for state-specific comparisons over time.