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A Taxing Matter

Changes in Government Revenue and Spending Priorities, 1950 - 1996

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Introduction

A major debate is taking place over how to reform the U.S. tax system. Proposals are on the table to replace the current federal income tax with a simpler "flat-rate" income tax or a national retail sales tax.[1] Federal tax reform figured prominently in the Republican Party presidential primaries and again during the general election.

In its January 1996 report to the American people, the National Commission on Economic Growth and Tax Reform (popularly known as the "Kemp Commission") gave voice to popular frustration with a tax system widely viewed as unfair and excessively burdensome:

> By learning the lessons of the past, we are more likely to arrive at consensus and wise decisions about how to change current tax policies.

> Over the years, Americans have surrendered more and more of their freedom to higher taxes. The result has not been to enhance economic security or to close the gulf between rich and poor. Instead, it has led to fewer jobs, slow economic growth, diminished hope and opportunity, an erosion of trust and confidence in government, and an ebbing of the American spirit of enterprise. It is a history that echoes James Madison's warning that "there are more instances of the abridgment of the freedom of the people by gradual and silent encroachments . . . than by violent and sudden usurpation."[2]

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This *Heartland Policy Study*, and a companion volume by the same authors titled "How Fair? How Efficient?" have been produced to provide background data and analysis for the national debate over tax policy that lies ahead.

In the current debate, surprisingly little is said about the decisions that were made in past years to shift reliance from one form of taxes to another, from one group of taxpayers to another, and from one level of government to another. Most people don't know what percentage of government revenue comes from income taxes, for example, or how that percentage has changed over the years. Similarly, few people know who benefits from the goods and services that are paid for by those taxes, even though that information is clearly relevant to measuring the fairness or justice of the tax system.

Most people don't know what percentage of government revenue comes from income taxes, for example, or how that percentage has changed over the years.

By studying the past, we can learn why the current tax and spending priorities were chosen (or spontaneously evolved), and decide whether those priorities are still (or were ever) valid. By learning the lessons of the past, we are more likely to arrive at consensus and wise decisions about how to change current tax policies.

Lessons from the Past

The past forty years have seen considerable change in the level of taxes as well as who collects and who pays taxes. For example:

- Federal, state, and local tax revenues all rose much faster than inflation or population growth since 1960. Individual tax burdens grew dramatically, relative to personal income, until the 1980s, when sustained economic growth and lower rates of inflation allowed personal income growth to keep pace with the rising cost of government.

- Government debt—a method of passing the burden of taxes forward in time to future taxpayers— and government regulations—a method of forcing businesses to carry the cost of accomplishing public goals—have increased dramatically and at every level of government.

- Federal and state governments have dramatically increased their reliance on income taxes as a source of revenue. State governments, for example, increased the share of their total receipts from this source from just 8.3 percent in 1950 to 31.9 percent in 1993.

- Revenues from taxes on property, corporate profits, and specific commodities fell, as a percentage of total revenues for all governments, until the mid-1990s. A new trend toward greater reliance on property and excise taxes, particularly by state and local governments, appears to have started in the mid-1990s.

According to a prominent school of thought in public finance circles, taxes are the price paid for public services and benefits.[3] Consequently, one cannot judge the fairness or efficiency of a tax system without also examining who benefits from public expenditures. In recent years, changes in how public funds are spent have also been dramatic:

- Spending on public welfare and other entitlement programs has risen dramatically relative to total spending, inflation, and population growth. In 1980, spending on Social Security and Medicare eclipsed national defense spending.

> Spending on public welfare and other entitlement programs has risen dramatically relative to total spending, inflation, and population growth.

- Spending on defense, highways, and other constitutionally required or basic government services that benefit all citizens has fallen steeply relative to other spending, although it has risen relative to inflation and population growth.

- Debt has been rising for all levels of government, causing interest payments to emerge as the fourth largest expenditure item, accounting for 10.2 percent of all government spending in 1992.

Organization of the Report

Part 1 examines total tax revenues by all levels of government between 1960 and 1992. Part 2 examines total government spending during the same period. Part 3 focuses on state taxes and spending from 1950 to 1993, and Part 4 looks at local taxes and spending between 1950 and 1992.

Part 5 examines preliminary data on state revenue between 1993 and 1995, state spending between 1992 and 1995, and state tax rates between 1994 and 1996. Spending on public aid and education appears to have stopped its rapid rate of increase relative to other forms of state government spending, while tax burden appears to be shifting away from personal income to general sales and excise taxes. Part 6 contains a summary and concluding remarks.

Endnotes and a statistical appendix containing the databases used to generate charts and tables appear at the end of the report.

Part 1
Total Government Revenues
1960 - 1992

How did revenue collections for all levels of government change between 1960 and 1992? To answer this question, we examined Bureau of the Census data for 1960 and 1992 and adjusted the figures for inflation and population growth.[4] To see if trends since 1980 were different from the long-term trends, we repeated the analysis using 1980 data.

> Real inflation-adjusted government tax collections per person more than doubled between 1960 and 1992.

A. Total Revenues

Between 1960 and 1992, annual revenues to all levels of government increased nearly 1,400 percent, from $153 billion to $2.3 trillion. Adjusted for inflation, the increase was 211 percent. If we further adjust for the 38.7 percent growth in population that occurred during this period, the increase was 121 percent.

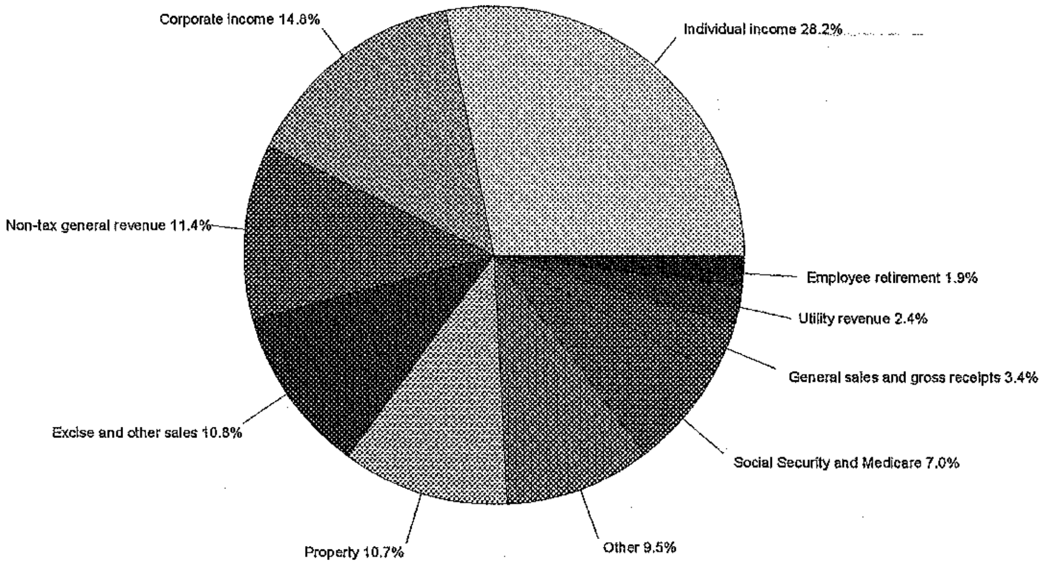
In plain language, real inflation-adjusted government tax collections per person more than doubled between 1960 and 1992. The most dramatic increase was in revenues generated by Social Security and Medicare taxes, which increased from $10.6 billion in 1960 to $394 billion in 1992, or 3,600 percent (681 percent after inflation).

Four revenue sources were responsible for 65.2 percent of all revenues in 1960: individual income taxes (28.2 percent), corporate income taxes (14.8 percent), non-tax general revenue (11.4 percent), and excise and other sales taxes (10.8 percent). Thirty-two years later, individual income taxes had fallen slightly as a share of total government revenues, to 26.2 percent; corporate income taxes fell dramatically to 5.5 percent; non-tax general revenue rose to 19.0 percent; and Social Security and Medicare taxes more than doubled their share of total revenues, rising from 7.0 percent to 17.4 percent. Excise and other sales taxes fell from 10.8 percent of all revenues to 4.0 percent.

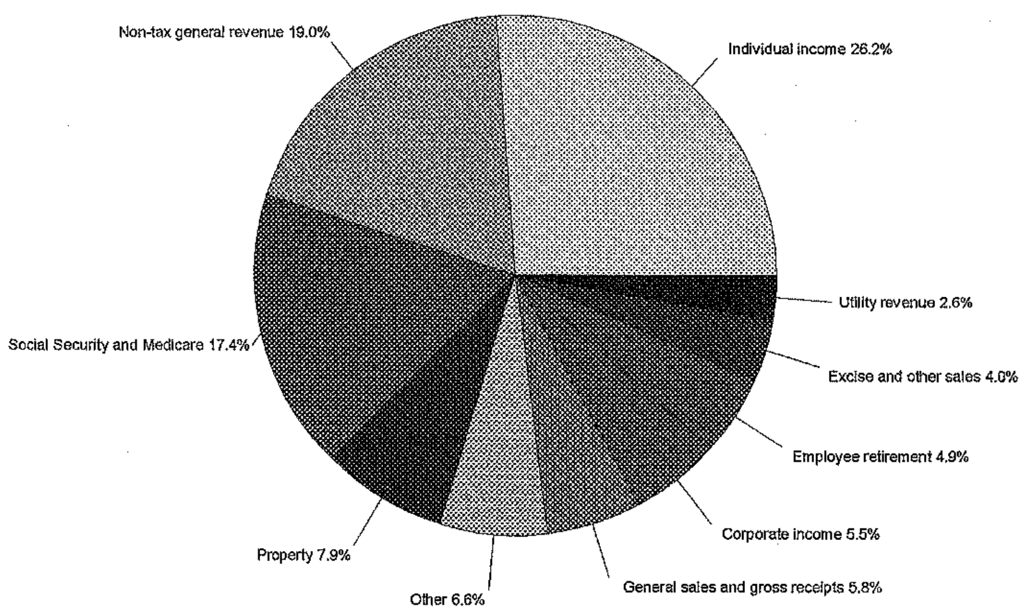
The rapid growth of Social Security and Medicare taxes during this period could, but does not, mask or distort the trends for other revenue sources. For example, income tax revenues accounted for a slightly larger share of all government revenues in 1992 than in 1960—31.7 percent versus 30.3 percent—when Social Security and Medicare are excluded. Income from excise and other sales taxes as a share of overall revenues still declines by approximately the same amount. Figures 1 and 2 on the facing page illustrate the change in tax revenue sources for all levels of government in the U.S. between 1960 and 1992. Underlying data can be found in Tables 1 and 2 in the appendix.

Figures 1 and 2
Composition of Total Government Revenues

1960



1992



1995 Tax Burden on the Typical American Family	
Median Family Income	**$52,039**
Federal income tax	4,926
Payroll Taxes	
Employee Share	3,822
Employer Share	3,822
Other Federal Taxes	2,244
Total Federal Taxes	14,814
Total State/Local Taxes	6,506
Total Taxes	**$21,320**
After Tax Income	$34,541
Taxes as a Percent of Income	**40.9%**

Source: Joint Economic Committee, *Economic Policy Update*, March 1996, citing Tax Foundation and U.S. Bureau of Census data.

B. Total Tax Burden

According to the Tax Foundation, taxes per capita in 1996 averaged $8,944, or 34.8 percent of per-capita income.[5] Of that total, federal taxes accounted for $5,910, and state and local taxes accounted for $3,034. The Joint Economic Committee of Congress, using a different methodology, estimates that the typical family in the U.S. paid 40.9 percent of its income in taxes in 1995. (See table on this page.)

Tax burden in the U.S. is at historical highs relative to gross national product and as a percent of personal income. The Tax Foundation uses the concept of a "Tax Freedom Day" to illustrate this growth.

In 1902, the entire earnings of an average U.S. citizen from 31 days of work would have been sufficient to pay his or her annual tax bill. Hypothetically, that person could have worked from January 1 to January 31 just to pay taxes. January 31 thus could be called "Tax Freedom Day." By 1930, 13 more days of work would have been required, moving Tax Freedom Day to February 13. In 1960, the date was April 16; in 1970, April 26; in 1990, May 2. In 1996, Tax Freedom Day landed on May 7. The average American worker in 1996 had to work 128 days just to pay his or her taxes. (See figure on the next page.)

Because state tax burdens vary, overall tax burden varies from state to state. Connecticut had the highest total tax burden in the nation in 1996, followed by New York, New Jersey, Minnesota, and Wisconsin. The state with the lowest tax burden was Alabama, followed by Mississippi, Missouri, Louisiana, and Delaware. (See table on the next page.)

C. Changes in Tax Rates

The combined employer-employee Social Security and Medicare tax was 2 percent when the program was enacted in 1937. The rate was doubled in 1954, and increased again to 6 percent in 1960. The tax rate reached 10.4 percent in 1971, 13.3 percent in 1981, and 15.3 percent in 1991, where it remains today.

Revenues generated by individual income taxes rose from $43.2 billion in 1960 to $592 billion in 1992. State income taxes vary widely in marginal rates and the number of income brackets, making a summary difficult. The federal individual income tax in 1960 had rates ranging from 20 percent to 88 percent. The top marginal rate fell to 60 percent in 1971 and to 50 percent in 1981. The Tax Reform Act of 1986 consolidated the rate schedule to five rates and lowered the top rate to 38.5 percent. After several more changes, the schedule today has five rates and a top rate of 39.6 percent.

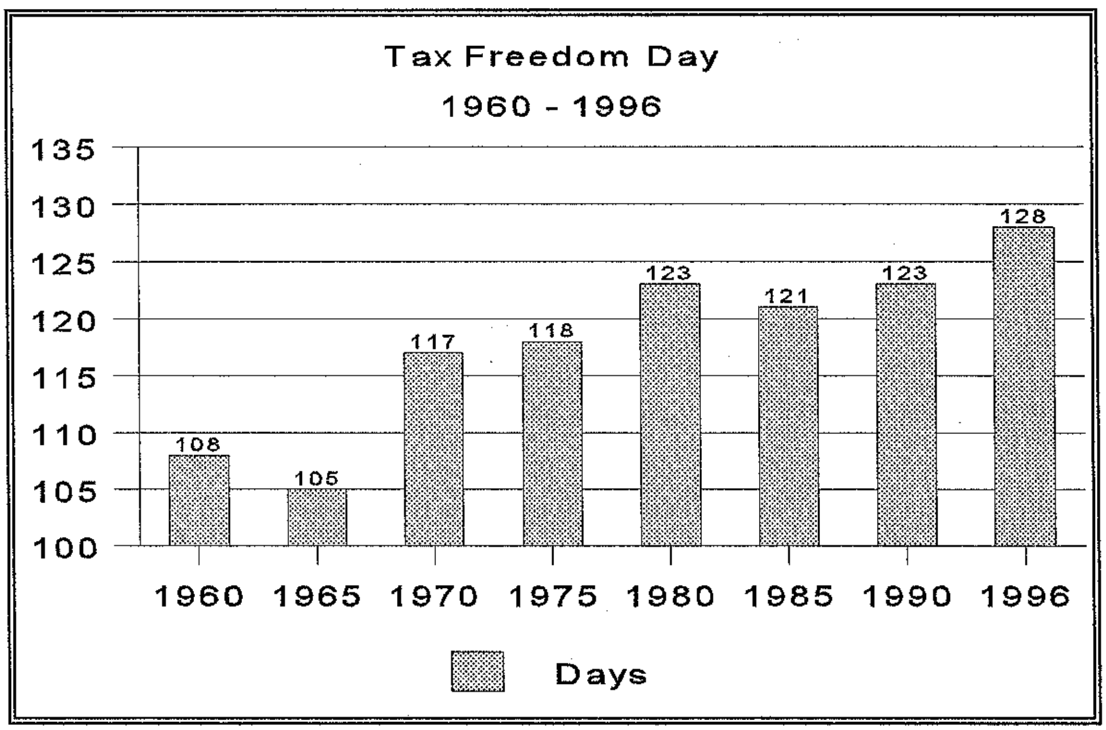
Total Tax Burden as a Percent of Personal Income, by State 1996

Highest Tax States	
Connecticut	41.4%
New York	40.2
New Jersey	37.8
Minnesota	36.9
Wisconsin	36.9
Lowest Tax States	
Delaware	31.6%
Louisiana	31.5
Missouri	31.3
Mississippi	31.3
Alabama	31.0

Source: Tax Foundation.

Rates under the federal corporate income tax have also been volatile. In 1960, corporations paid 22 percent on the first $25,000 in profits and 48 percent on any amount above that. During the 1980s, the schedule was expanded to five rates ranging from 15 percent to 46 percent. During the 1990s, rates ranged from 15 percent to 35 percent.

Between 1960 and 1992, revenues from excise taxes on alcohol, gasoline, tobacco, and "other sales taxes" (not general sales taxes) rose 451



percent, from $16.5 billion to $91.2 billion. After adjusting for inflation, the increase was just 16.2 percent, and adjusting for population reveals that the real per-person tax burden actually fell 17.4 percent.

Excise taxes are often levied on a per-unit basis (per gallon in the case of alcohol and gasoline, and per pack or carton in the case of cigarettes), and for that reason they did not keep pace with the rapid price inflation of the 1960s and 1970s.[6] Collections from income and general sales taxes, on the other hand, rose with rising prices, outpacing both consumption and income growth during the same period. Income tax receipts grew fastest as taxpayers were pushed into higher tax brackets, a phenomenon called "bracket creep."[7]

Overall, the sources of government tax revenues between 1960 and 1992 shifted toward payroll taxes—especially Social Security and Medicare taxes—and general sales taxes and away from taxes on property, corporate profits, and specific commodities. Social Security and Medicare tax rates increased significantly during this period, while the top marginal tax rates on individual income and corporate profits fell.

> All told, average Americans work for the government 193 days each year before they can begin working for themselves.

D. Non-Tax Government Burdens

While taxes are the most visible burden imposed by governments on their citizens, it is wrong to overlook other burdens that influence the fairness and efficiency of the U.S. tax system. Four additional burdens are most notable:

- **Cost of complying with the tax code.** The Tax Foundation estimates that Americans will spend $235 billion complying with federal, state, and local tax codes in 1996. This is more than half as much as all state taxes collected in 1996. If added to Tax Freedom Day, the cost of compliance would push the date forward by 13 days.

- **Cost of future obligations (debt).** During 1996, the federal government spent $144 billion more than it raised through taxes. This amount of debt was incurred by taxpayers, even though it was not paid in taxes. Because it will eventually have to be paid, the amount is essentially the same as a tax. If added to Tax Freedom Day, debt would move the date forward by eight days.

- **The inflation tax.** When government inflates the money supply, it causes prices to rise. Price inflation is similar to an income tax since it reduces the purchasing power of a given holding or income by the rate of inflation. The federal government receives the receipts of the inflation tax when it issues new dollars, and taxpayers "buy" the new money to bring their real money balances back to their pre-inflation levels.[8] Inflation during 1994 was the same as a federal income tax of 2.6 percent with no exclusions or deductions. That tax cost taxpayers $142 billion, enough to add eight more days to "Tax Freedom Day."

- **The cost of regulation.** According to the Center for the Study of American Business, businesses spend $677 billion a year complying with government regulations.[9] The cost of regulation, like inflation, is the same as a tax paid by every consumer in the U.S. When added to Tax Freedom Day, the cost of regulation pushes ahead by 37 days the date when taxpayers are able to begin working for themselves.

To reflect the true cost of government, Tax Freedom Day has to be pushed ahead a startling 66 days, from May 7 to July 12. Average Americans, in other words, have to *work for the government 193 days each year* before they can begin working for themselves. Taxpayers are allowed to keep the income earned from working the remaining 172 days each year.

E. Total Tax Revenues from 1980 to 1992

If we turn our attention to the final twelve years of the statistical record, we find several new trends. Figures 3 and 4 on the following page illustrate the changes. Underlying data can be found in Tables 3 and 4 in the appendix.

> Real inflation-adjusted government tax collections per person increased by over one-fourth between 1980 and 1992.

Total Tax Burden

Total government revenues continued to rise faster than inflation and population between 1980 and 1992. Tax revenues rose from $932 billion in 1980 to $2.26 trillion in 1992, an increase of 142.5 percent. Controlled for inflation, the increase was 42.4 percent. After further adjusting for population growth, the increase was 27.3 percent. In plain language, real inflation-adjusted government tax collections per person increased by over one-fourth between 1980 and 1992.

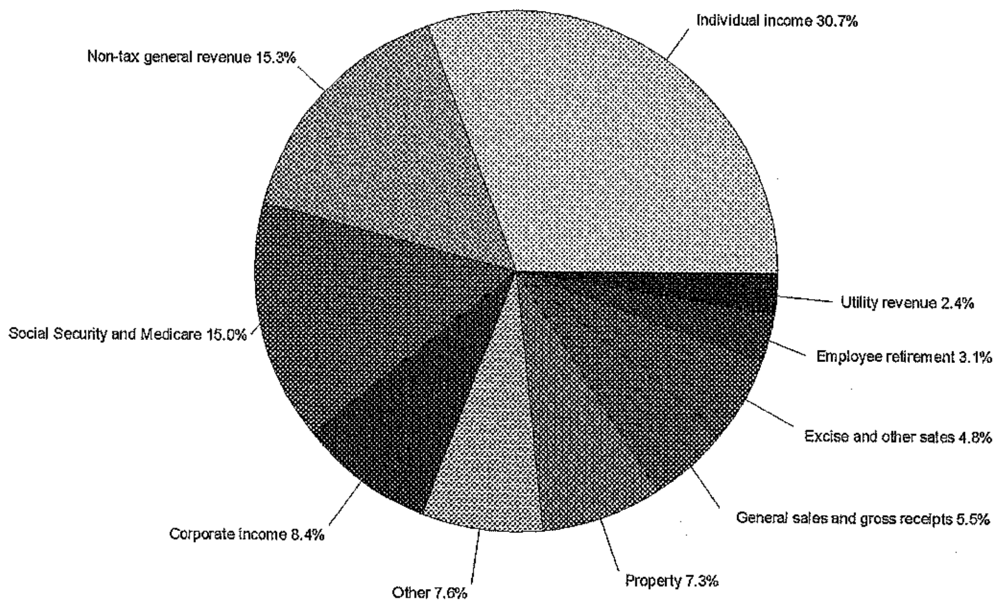
Tax Freedom Day retreated by three days between 1980 and 1992, a dramatic departure from the long-term trend described earlier. The number of days the average American needed to work to pay his taxes was 123 days in 1980 and 120 days in 1992. During the years between 1980 and 1992, the number of days retreated to as few as 119 in 1984 and moved ahead to as many as 126 in 1981. (See figure on page 11.)

Fast-Growing Revenue Sources

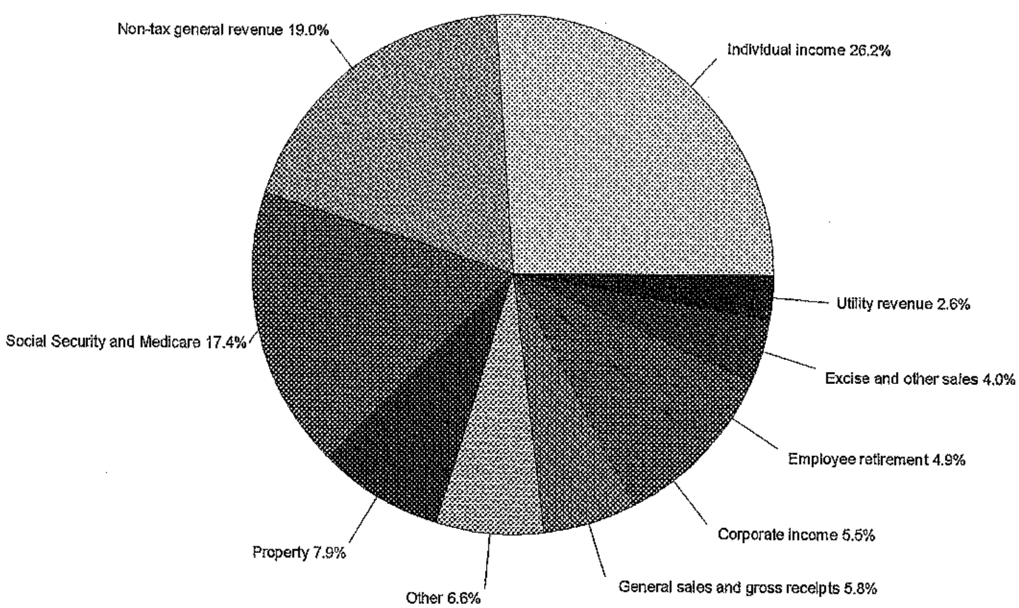
The four fastest growing revenue sources from 1980 to 1992, besides nontax general revenues, were employee retirement savings, Social Security and Medicare, utility taxes, and

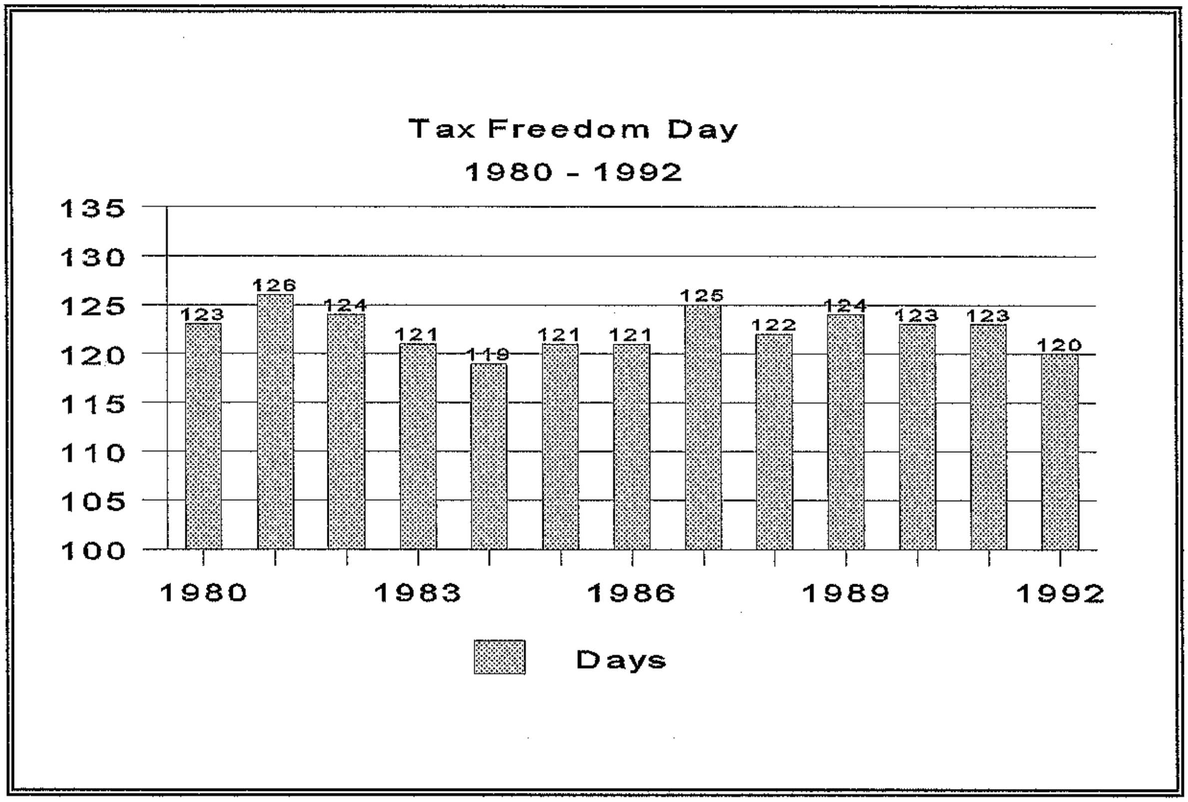
Figures 3 and 4
Composition of Total Government Revenues

1980



1992





property taxes. Revenues for employee retirement grew due to the rapid growth in government employment and compensation during the 1970s and 1980s, an aging workforce, and generous retirement benefits.[10] Social Security and Medicare taxes rose, due to the tax rate increases described earlier, from $139 billion in 1980 to $394 billion in 1992, an after-inflation increase of 66 percent, and grew from 15 percent of total government revenues to 17.4 percent.

Utility taxes grew as state and local governments discovered that they could require utilities to collect taxes on their behalf. Property taxes increased slightly as a share of total government revenues during the 1980s, rising from 7.3 percent to 7.9 percent, reversing a trend from the 1960s and 1970s.

Adjusted for inflation and population growth, the four fastest growing revenue sources between 1980 and 1992 grew at the following rates:

- Employee retirement, up 100 percent;
- Social Security and Medicare, up 48 percent;
- Utility taxes, up 38 percent; and
- Property taxes, up 37 percent.

Slow-Growing Revenue Sources

The slowest growing revenue sources from 1980 to 1992 were corporate income taxes, death and gift taxes, excise and other sales taxes, and individual income taxes. Corporate income taxes fell from 8.4 percent of all revenues to 5.5 percent, perhaps due to escalating competition among states for businesses.[11]

> *All* of the decline in reliance on individual income taxes observed in the long-term trend occurred during the 1980s.

Individual income taxes declined as a percentage of total government revenues, from 30.7 percent in 1980 to 26.2 percent in 1992. This reveals that *all* of the decline in reliance on individual income taxes observed in the long-term trend occurred during the 1980s. Part 2 below will reveal that states actually increased their reliance on income taxes during this period, meaning changes in federal income tax policies accounted for all of the decline in reliance on income taxes during this period.

The change in revenues for the four slowest growing sources of revenue from 1980 to 1992, adjusted for inflation and population growth, were:

- Corporate income taxes, - 16 percent;
- Death and gift taxes, - 3 percent;
- Excise and other sales taxes, up 8 percent; and
- Individual income taxes, up 9 percent.

The share of total revenue produced by excise taxes and other sales taxes (not general sales taxes) declined from 4.8 percent to 4.0 percent. Adjusted for inflation and population, total revenues from this source nevertheless rose 8 percent during this period, reversing the long-term trend toward lower real per-capita burdens.

Two factors were largely responsible for the new trend: The lower inflation rates of the 1980s, and rising motor fuel taxes. The latter rose 71 percent in inflation-adjusted dollars, and grew from 1.6 percent of total revenues in 1980 to 1.9 percent in 1992. The cause of this increase was a series of tax rate increases at the national and state levels, as shown in the table on the following page.

F. Summary and Conclusion

In summary, total government revenues during the 1980s continued some of the trends observed since 1960, most notably the rising reliance on Social Security and Medicare payroll taxes and nontax general revenue. However, the 1980s departed from the trends revealed during the previous two decades in four notable ways:

- First, total tax revenue stopped growing relative to personal income, as is revealed by Tax Freedom Day falling back three days. Total tax revenues did, however, continue to grow faster than inflation and population growth. Also, as is shown by the figure on page seven, this fall in relative tax burden was due to be reversed again during the 1990s.

- Second, reliance on individual income taxes fell by approximately 15 percent, from 30.7 percent of all revenues to 26.2 percent.

- Third, excise taxes rose relative to inflation and population growth, although their revenues continued to fall relative to total tax revenues.

- And fourth, a long-term trend away from property taxes was reversed, as reliance on revenues from this source rose 8.2 percent, from 7.3 percent to 7.9 percent of all tax revenues.

Federal and Average State Motor Fuel Taxes, 1982 - 1996

Year	Federal	Average State	Total
1982	$0.040	$0.100	$0.14
1983	0.040	0.110	0.15
1984	0.090	0.120	0.21
1985	0.090	0.120	0.21
1986	0.090	0.130	0.22
1987	0.091	0.140	0.231
1988	0.091	0.140	0.231
1989	0.091	0.160	0.251
1990	0.141	0.160	0.301
1991	0.141	0.170	0.311
1992	0.141	0.180	0.321
1993	0.141	0.180	0.321
1994	0.184	0.185	0.369
1995	0.184	0.185	0.369
1996	0.184	0.190	0.374

Source: Tax Foundation, U.S. Department of Transportation.

By 1992, the nation's tax system was less progressive and less burdensome on the average taxpayer than it was in 1980. In both cases, this required a major departure from the trends of the 1960s and 1970s.

Part 2
Total Government Spending
1960 - 1992

A. Total Government Spending

Annual expenditures by all levels of government in the U.S. increased 1,545 percent between 1960 and 1992, rising from $151.3 billion to $2.5 trillion. Adjusted for inflation, the increase was 247 percent, and adjusting further for population growth reveals real per-capita spending growth of 147 percent. In other words, government spending per person, in inflation-adjusted dollars, more than doubled between 1960 and 1992.

> Government spending per person, in inflation-adjusted dollars, more than doubled between 1960 and 1992.

Another way to illustrate the size of government spending is to compare it to gross domestic product (GDP), the value of the goods and services produced by the U.S. economy each year.[12] In 1960, spending by all levels of government was equal to 30 percent of GDP. In 1992, government spending amounted to 42 percent of GDP.

Focusing on direct government expenditures could lead one to overlook large amounts of "off budget" spending, loan programs, and unfunded liabilities for major entitlement programs. Payments to Social Security beneficiaries, for example, are currently expected to exceed tax revenues around the year 2012, and the system's trust fund (itself arguably a fictitious entity) may be exhausted by the year 2029.[13] Similarly, unfunded pension liabilities amounting to hundreds of billions of dollars are carried by state and local governments without being reported as current expenses or debt.

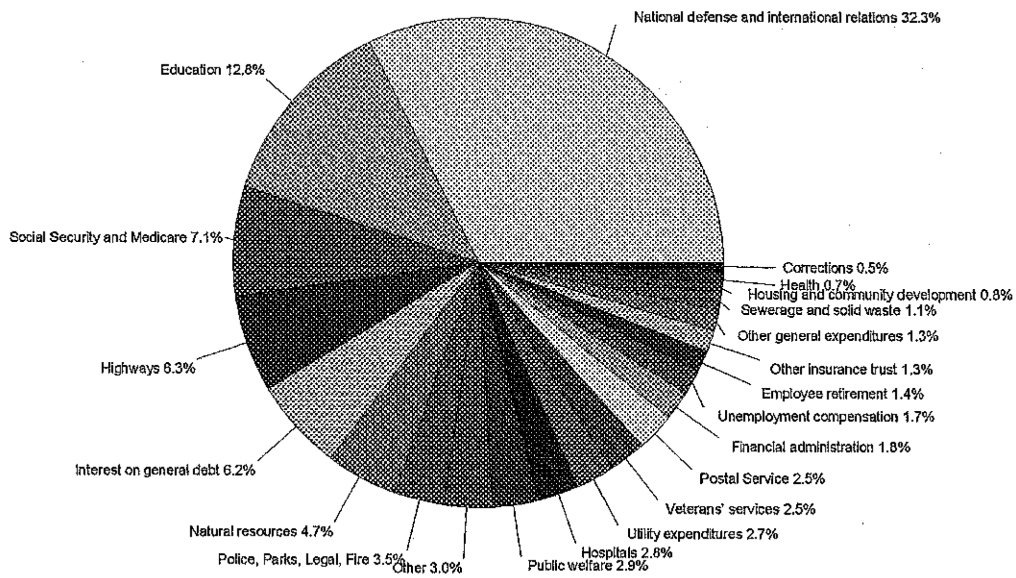
Estimates of government spending also overlook the indirect effects of government spending. Government spending through the Medicare and Medicaid programs, for example, profoundly affects the health care industry by fueling price-insensitive demand for medical services. After decades of double-digit annual growth, health care spending during the first half of the 1990s finally slowed due to widespread implementation of managed care. Government subsidies to housing and agriculture are other examples of how direct spending by government only begins to suggest the extent of government's involvement in the private economy.

B. Changing Priorities

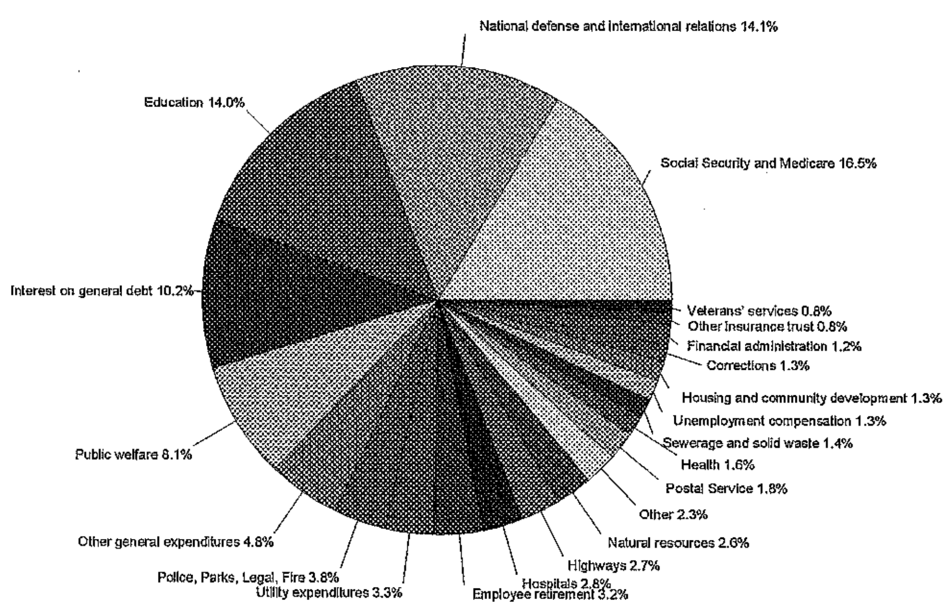
Spending priorities changed dramatically between 1960 and 1992, as illustrated by Figures 5 and 6 on the following page.

Figures 5 and 6
Composition of Total Government Spending

1960



1992



In 1960, spending on national defense accounted for nearly a third of all government spending, as much as the next four largest spending categories combined. By 1992, national defense spending was eclipsed by spending on Social Security and Medicaid and was almost the same as spending on education. Four areas of government (besides a catch-all category titled "other general expenditures") grew fastest during this period:

> Real per-capita spending on public welfare increased nearly six-fold between 1960 and 1992.

- Annual spending on **public welfare** rose 4,435 percent, 857 percent after taking inflation into account, and 580 percent after further controlling for population growth. Welfare spending rose from 2.9 percent of total government spending in 1960 to 8.1 percent in 1992.

- **Corrections** spending rose 4,209 percent, 809 percent when adjusted for inflation, and 546 percent when adjusted for population growth. Corrections spending accounted for 1.3 percent of total spending in 1992, up from 0.5 percent in 1960.

- **Social Security and Medicare** spending rose 3,705 percent, 702 percent when adjusted for inflation, and 470 percent when further adjusted for population growth. This category of spending more than doubled its share of total government spending during this period, increasing from 7.1 percent to 16.5 percent.

- Government spending on **health** (not including hospitals or Medicare) rose 3,679 percent, 697 percent when adjusted for inflation, and 467 percent when further adjusted for population growth. Like corrections, this category of spending is too small (0.7 percent in 1960, and 1.6 percent in 1992) to have much impact on overall government spending.

The four **slowest** growing areas of government from 1960 to 1992 had purposes and beneficiaries that differed considerably from the fast-growing entitlement programs:

- Annual spending on **veterans' services** rose 439 percent, 13.7 percent after controlling for inflation, and - 19.0 percent when adjusted for population growth. Like corrections and health, this is a small category of spending (0.8 percent in 1992).

- Spending on **highways** rose 605 percent, 49 percent in inflation-adjusted dollars, and 6 percent when adjusted for population growth. Unlike veterans' benefits, highway spending was once a major government funding priority, ranking fourth (behind national defense, education, and Social Security and Medicare) and accounting for 6.3 percent of all spending in 1960. By 1992, however, it had fallen to eleventh place with 2.7 percent of total spending.

- **National defense** grew 619 percent in current dollars, 52 percent in inflation-adjusted dollars, and 8 percent when adjusted for population growth. National defense spending fell from 32.3 percent of all spending in 1960 to 14.1 percent in 1992.

- Spending on **natural resources** rose 811 percent, 92 percent after inflation, and 37 percent when adjusted for population growth. This category includes forestry and management of public lands.

A major expense item that also rose rapidly during this period was **interest on debt** at all levels of government. Gross government debt rose from $356.2 billion in 1960 to $5.0 trillion in 1992. Interest payments rose from 6.2 percent of total spending to 10.2 percent. In 1992 interest was the fourth largest expense for government. While attention often focuses on the rising federal debt (properly so since it accounts for some 80 percent of all government indebtedness), the federal government's share of total government debt remained almost unchanged from 1960 to 1992. (See table on this page.)

Gross Government Debt
1960 versus 1992

1960	**$ (billions)**	**%**
Federal	$286.3	80.4
State	18.5	5.2
Local	51.4	14.4
Total	356.2	100.0
1992		
Federal	$4,082	80.8
State	372	7.4
Local	598	11.8
Total	5,052	100.0

Source: Department of Commerce, Bureau of the Census

C. Winners and Losers

With the exception of corrections, the categories of spending that rose the fastest since 1960 were state and federal entitlement programs. Unlike the national defense and highway spending they replaced, these programs are not intended to fulfill a constitutionally required duty of government or to benefit all citizens equally. Instead, they are the outgrowth of New Deal and Great Society social programs designed to create a "safety net" under society's neediest populations.

Spending on Social Security and Medicare, public welfare, and health tends to benefit only those individuals who qualify for entitlement programs. Since these programs are generally means-tested, recipients tend to pay in taxes less than the value of the benefits they receive. Between 1960 and 1992, spending on these three categories rose from 10.7 percent of all spending to 26.2 percent. Other categories of spending that are similarly redistributive, such as education, unemployment compensation, and housing and community development, also saw rapid growth during this period.

By contrast, spending on programs intended to fulfill constitutional duties or to benefit all taxpayers lost considerable ground since 1960. Spending on national defense, highways, corrections, police, parks, fire protection, and legal and judicial services, stood at 42.6 percent of total spending in 1960, but had fallen to 21.9 percent in 1992.

The story of government spending between 1960 and 1992 can be summarized as three trends:

> The story of government spending between 1960 and 1992 can be summarized as significant trends toward payment of interest on debt and funding entitlement programs for the benefit of the needy.

- Total spending rose dramatically relative to inflation, personal income growth, and gross domestic product.
- Increasing priority was given to payment of interest on debt and funding entitlement programs for the needy.
- Receiving relatively less funding, but more in real, per-capita dollars, were constitutionally required services and services that benefit all taxpayers, most notably national defense and highways.

D. Government Spending from 1980 to 1992

Examining spending by all levels of government from 1980 to 1992 reveals new short-term trends that give us some insight into changing public demands and political compromises.

Total Spending

Annual total government spending increased 160 percent between 1980 and 1992, from $958.7 billion to $2.5 trillion. Adjusted for inflation, total spending rose 52.5 percent. Per-capita real spending rose 36.2 percent. These figures are higher than those previously reported for government revenue growth: per-capita real tax revenues grew by 27.3 percent during the same period. Most of the difference appeared as public debt during this period.

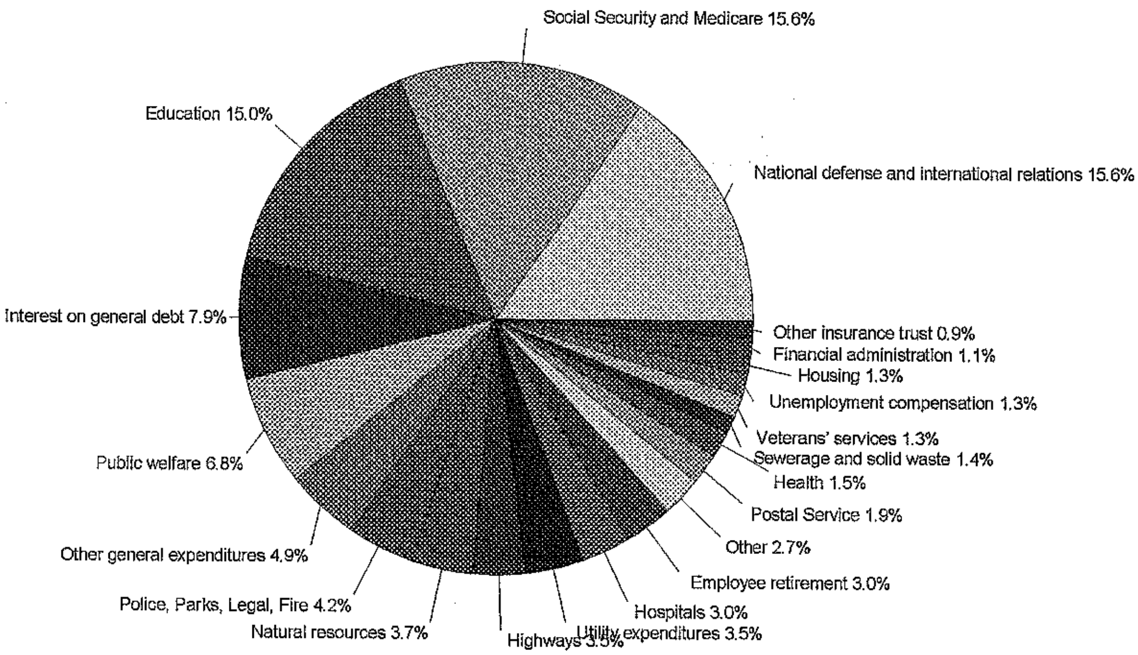
Changing Priorities

Spending on national defense and Social Security and Medicare met in 1980, with each category accounting for 15.6 percent of total spending. Interest on debt was already the fourth largest spending item for all levels of government by 1980 (before the infamous "Reagan deficits"). Public welfare had moved up from ninth place in 1960 to fifth place in 1980 with 6.8 percent of total spending.

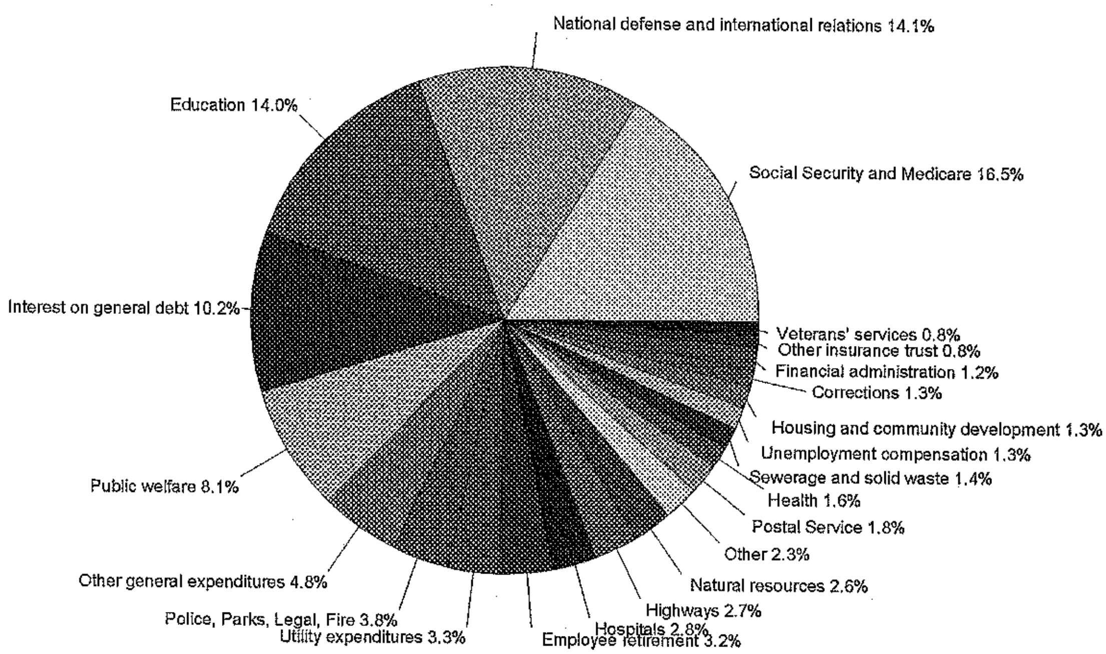
Figures 7 and 8 on the following page illustrate the changes in government spending priorities between 1980 and 1992. Underlying data can be found in Tables 7 and 8 in the appendix. The fastest growing government programs during the 1980s, after controlling for inflation and population growth, were the following:

Figures 7 and 8
Composition of Total Government Spending

1980



1992



- Corrections, up 139 percent;
- Interest on general debt, up 76 percent;
- Judicial and legal system, up 71 percent;
- Public welfare, up 64 percent.

Real per-capita Social Security and Medicare spending rose 44.3 percent from 1980 to 1992 and replaced national defense as the largest single category of spending. Education spending remained the third largest category of spending, rising 27.2 percent in real, per-capita terms. Spending grew most slowly, relative to other government programs, in the following areas (once again the percentages are adjusted for inflation and population growth):

Changes in spending priorities during the 1980s represented the beginning of the end of the major trends of the 1960s and 1970s.

- Veterans' services, down 14 percent;
- Natural resources, down 4 percent;
- Highways, up 5 percent;
- National defense, up 23 percent.

Changes in spending priorities during the 1980s represented the beginning of the end of the major trends of the 1960s and 1970s. The new trends include the following:

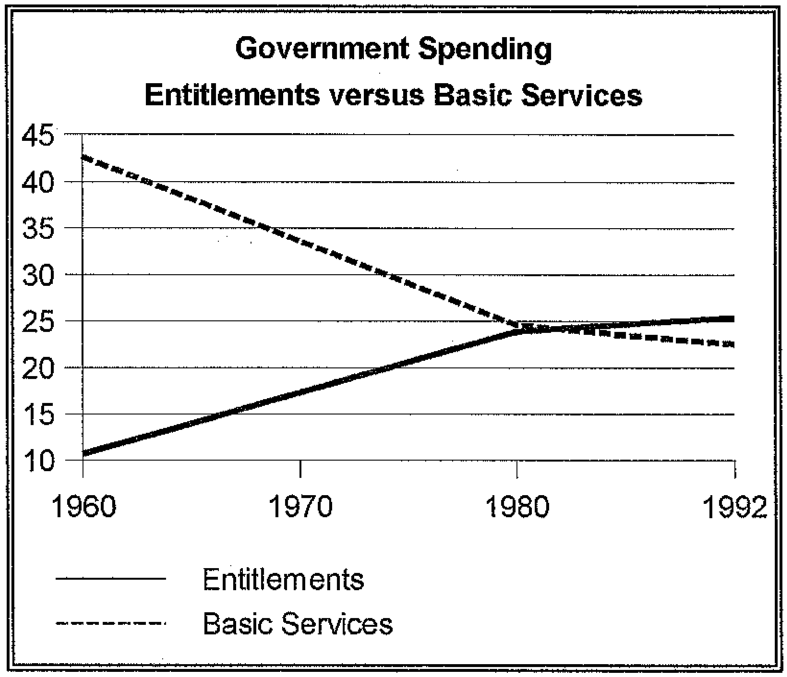
- Public welfare and Social Security and Medicare increased their shares of total government spending at a much slower rate than occurred during the previous two decades. Spending on public welfare rose from 6.8 to 8.1 percent of all spending, while Social Security and Medicare's share of total government spending rose by just under one percentage point (from 15.6 percent to 16.5 percent).
- Education spending actually fell one percentage point relative to overall spending, from 15.0 percent to 14.0 percent, reversing the trend of the previous two decades, as enrollments flattened and hikes in teacher salaries slowed.
- The rapid increase in spending on corrections reveals that most of the increase observed during the long-term trend (1960 to 1992) in fact occurred since 1980. Corrections spending stood at 0.5 percent of total spending in 1960, 0.7 percent in 1980, and 1.3 percent in 1992.
- Most of the decline in national defense spending relative to other government programs occurred during the 1960s and 1970s, as revealed by the fact that national defense spending had already fallen to 15.6 percent of total spending by 1980. The 23 percent increase relative

to inflation and population growth since 1980 is dramatically better than the 8 percent rate of increase recorded during the long-term period.

- Spending on police, parks, legal and judicial system, and fire protection rose more slowly relative to other spending categories during the 1980s than it did during the two previous decades. Spending for this group of services stood at 3.5 percent in 1960, 4.2 percent in 1980, and 3.8 percent in 1992.

Winners and Losers

Spending on Social Security and Medicare, public welfare, and health—the three entitlement programs that grew fastest since 1960—stood at 23.9 percent in 1980, compared to 10.7 percent in 1960 and 26.2 percent in 1992. Spending on programs intended to benefit all taxpayers—national defense, highways, corrections, police, parks, fire protection, and legal and judicial services—stood at 24.0 percent in 1980, compared to 42.6 percent of total spending in 1960 and 21.9 percent in 1992.



These numbers suggest that while the trend toward entitlements and away from basic services continued during the 1980s, the pace of the trend was dramatically slowed. The graph on this page illustrates the trend.

Conclusion

The 1980s witnessed the continued growth of government spending at rates that were much higher than inflation or population growth. However, it also witnessed a dramatic slowing, but not the end, of the trend away from constitutionally required services and services that benefit everyone and toward the entitlement programs of the New Deal and Great Society eras. Public support apparently grew for greater public spending on crime prevention and the justice system, slower reductions in national defense vis-a-vis other kinds of government spending, and a slower rate of increase in spending on Social Security and Medicare and other entitlement programs. Spending on national defense, highways, and natural resources continued to fall relative to other spending, but at a much reduced rate.

Part 3
State Government Revenues and Spending
1950 - 1993

To read some accounts, one would think that America is experiencing a crisis in federalism. Declining federal aid to state and local governments and "belt-tightening" by state governments, it is said, are leading to a fiscal crisis at the local level. In December 1995, for example, *State Budget & Tax News* reported the following:

> The virtual moratorium on state tax increases has deprived local officials of the new money they traditionally receive as shares of total state revenues, a particularly common practice with gas taxes and other highway user charges. States are not stepping in to replace lost federal aid. Cuts in federal aid have automatically reduced state aid in situations, common in transportation and environmental protection, where states share in non-federal costs.

Real per-capita state tax revenues nearly quadrupled between 1950 and 1993.

The reality is somewhat different. While federal aid fell as a share of state and local spending between 1977 and 1987, it has since rebounded to record high levels. In 1995, it accounted for a larger share of state and local spending than it did in either 1985 or 1975.[14] This increase in share occurred during a period of relatively rapid growth in state and local spending. It is true that local governments have seen less federal aid since the heydays of the mid-1970s. But federal aid has historically been only a small part of local budgets: it was just 1.3 percent in 1950.

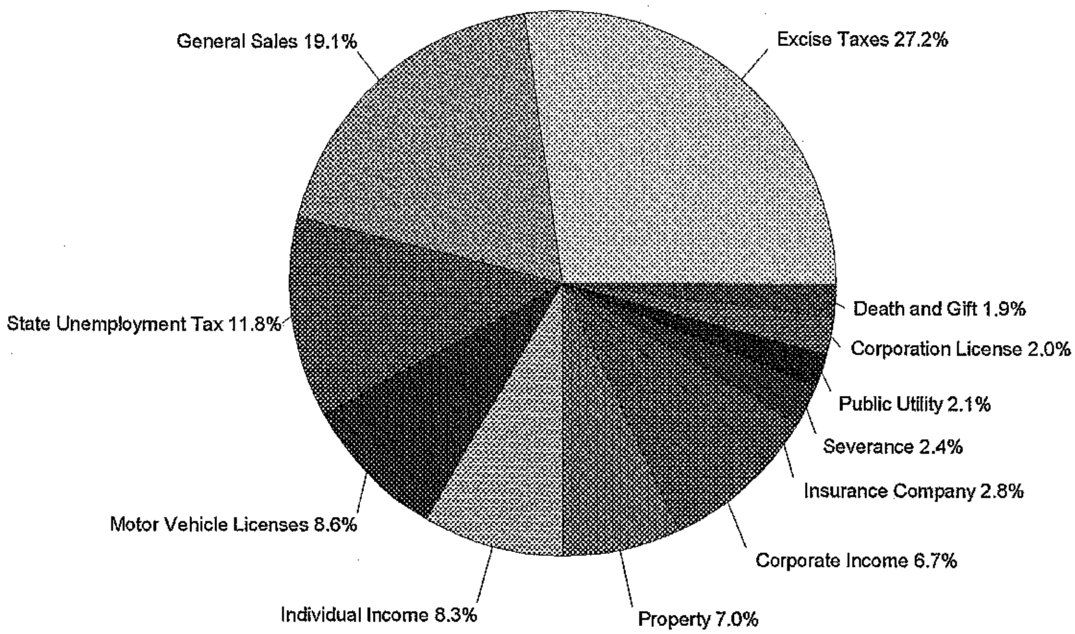
A. State Revenues from 1950 to 1993

U.S. Census Bureau data on state revenues and spending are available for as far back as 1950 and, at the time of this writing, as recently as 1993. During that 44-year period, annual state revenues increased nearly 4,000 percent, from $8.7 billion to $353.1 billion. Adjusted for inflation, the increase was 574 percent; further adjusted for population growth, the increase was 297 percent.[15] Real per-capita state tax revenues, in other words, nearly quadrupled between 1950 and 1993.

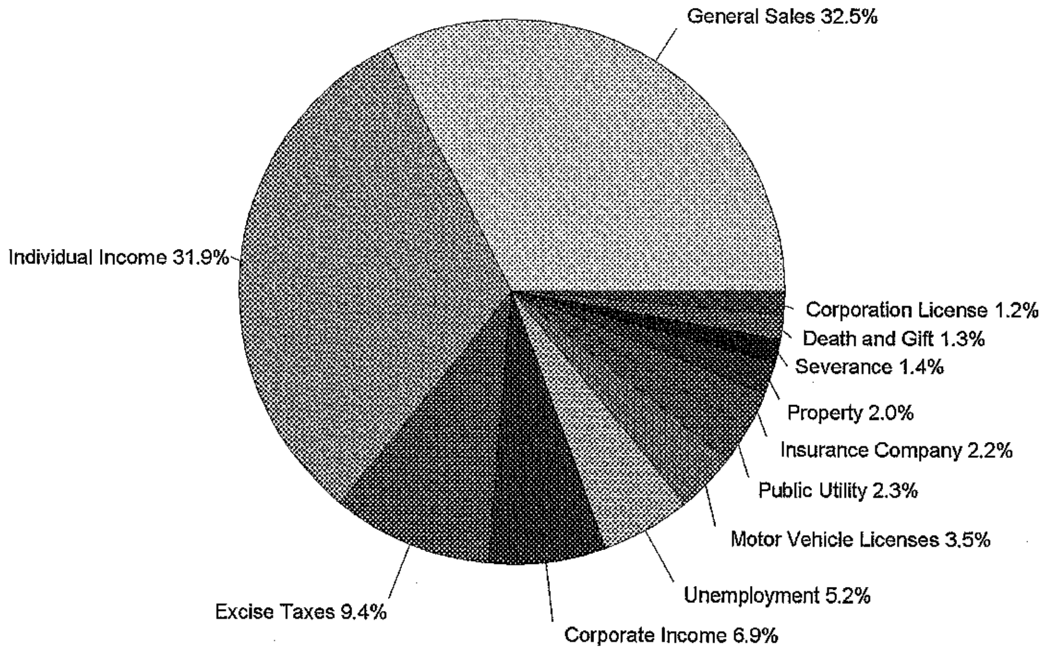
Figures 9 and 10 on the facing page illustrate the change in sources of state revenue between 1950 and 1993. Underlying data can be found in Tables 9 and 10 in the appendix.

Figures 9 and 10
Composition of State Government Revenues

1950



1993



The fastest growing revenue sources for state governments during this period, after adjusting for inflation and population growth, were the following:

- Annual revenues from income taxes increased 1,427 percent;

> From 1950 to 1993, real per-capita state income tax revenues increased 1,423 percent.

- Receipts from general sales taxes rose 576 percent;
- Utility tax receipts increased 339 percent; and
- Corporate income tax revenues rose 306 percent.

The slowest growing state revenue sources since 1950 were the following:

- Property taxes, up 14 percent after adjusting for inflation and population growth;
- Excise taxes, up 37 percent;
- Motor vehicle and operators licenses, up 63 percent; and
- Unemployment taxes, up 77 percent.

State revenue growth since 1950 has been so rapid that even the slowest growing revenue source—property taxes—grew faster than inflation and population growth. Real per-capita excise taxes, for example, which lost ground to income and general sales taxes during this period, nevertheless increased in real per-capita terms by over one-third. And the increase in income tax collections was phenomenal: 1,427 percent after controlling for inflation and population growth.

State-level property taxes became increasingly rare, falling from 7.0 percent of state revenues in 1950 to 2.0 percent in 1993 as this tax became the preferred revenue source of local governments. Taxes on personal property and business equipment, which were administered by state governments in many states during the 1950s and 1960s, were gradually eliminated for competitive reasons and because they were expensive to collect.

Excise taxes, as noted earlier, generally do not rise with price inflation, and therefore fell behind other types of taxation (such as income and general sales) since 1950. It also appears clear that at the state level, at least, excise taxes were being replaced by general sales taxes, total revenues from which increased six-fold. Many of the commodities previously subject only to an excise tax were now subject to dual taxation.

B. State Revenues from 1980 to 1993

Total Revenues

Between 1980 and 1993, annual state revenues increased by 141 percent, from $146.5 billion to $353.1 billion. Real per-capita state revenues grew by 22 percent between 1980 and 1993, about one-third less than the increase in revenues for all levels of government from 1980 to 1992. Total state revenues rose from 5.54 percent of gross domestic product in 1980 to 5.64 percent in 1993.

> Real per-capita state revenues grew by 22 percent between 1980 and 1993.

Changing Sources of Revenue

Figures 11 and 12 on the following page illustrate the change in state revenue sources between 1980 and 1993. Underlying data can be found in Tables 11 and 12 in the appendix. The fastest growing sources of state revenues during this period, after adjusting for inflation and population growth, were the following:

- Corporate licenses, up 58 percent;
- Individual income taxes, up 53 percent;
- General sales taxes, up 34 percent; and
- Insurance company taxes, up 28 percent.

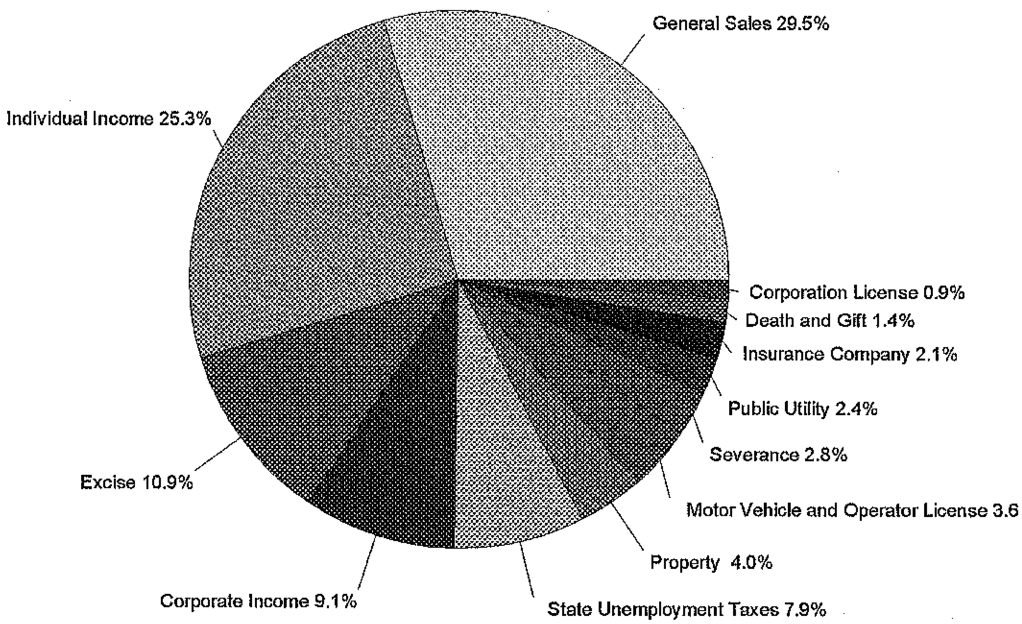
The slowest growing sources of revenue, after adjusting for inflation and population growth, were the following:

- Severance taxes, down 41 percent;
- Property taxes, down 39 percent;
- Unemployment taxes, down 20 percent; and
- Corporate income taxes, down 8 percent.

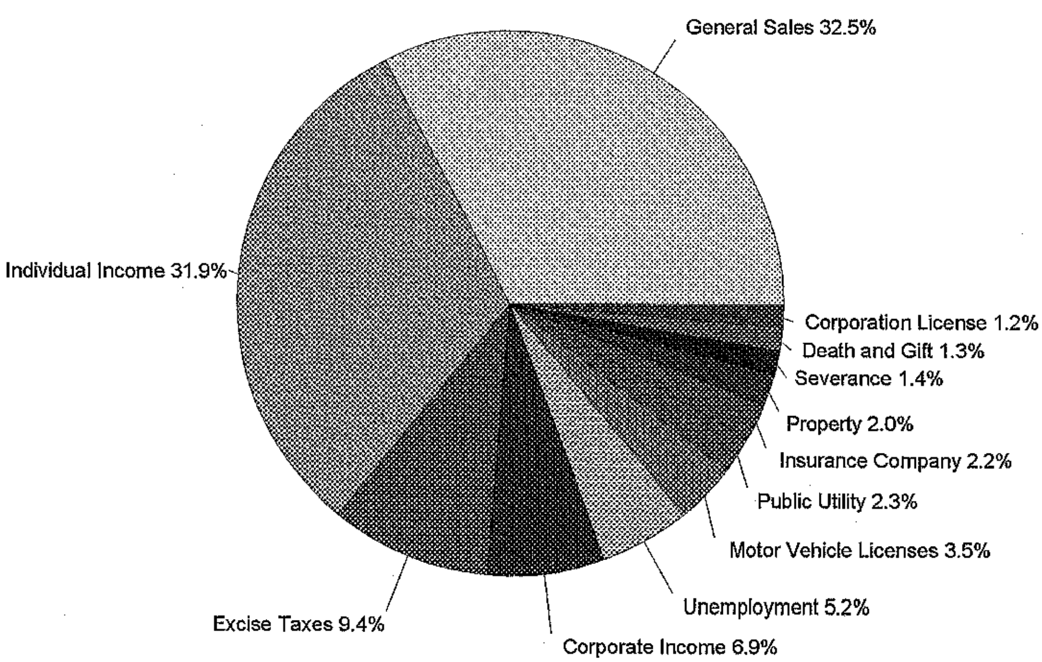
General sales and individual income taxes continued the pattern of growth relative to other sources of tax revenue observed during the long-term trend, with individual income taxes growing

Figures 11 and 12
Composition of State Government Revenues

1980



1993



from 25.3 percent of state revenues to 31.9 percent. Corporate license and insurance company taxes, though fast growing, accounted for less than 4 percent of all state revenues in 1993.

Excise taxes continued to decline relative to other tax revenue sources, falling from 10.9 percent to 9.4 percent of all state revenues, but rose 5 percent relative to inflation and population growth. The real per-capita increase in state excise taxes was about two-thirds as much as the 8 percent increase reported earlier for all levels of government during this same period, suggesting that reliance on this source grew fastest at the federal and local levels of government.

All four of the slowest growing taxes saw falling real per-capita collections from 1980 to 1993, another departure from the long-term period. Corporate income taxes, for example, down 8 percent between 1980 and 1993, had risen 306 percent from 1950 to 1993.

> The real per-capita increase in state spending between 1952 and 1993 was 451 percent. This was considerably faster than the 297 percent growth in real per-capita state tax revenues during the same period.

C. State Spending, 1952 - 1993

Total Spending

Between 1952 and 1993, annual state expenditures increased 4,736 percent, from $10.8 billion to $521.7 billion. Adjusted for inflation, the real increase was 790 percent. Further adjusted for population growth, the increase was 451 percent. This is considerably faster than the 297 percent growth in real per-capita state tax revenues between 1950 and 1993. State spending grew from 3.2 percent of gross domestic product in 1952 to 8.3 percent in 1993.

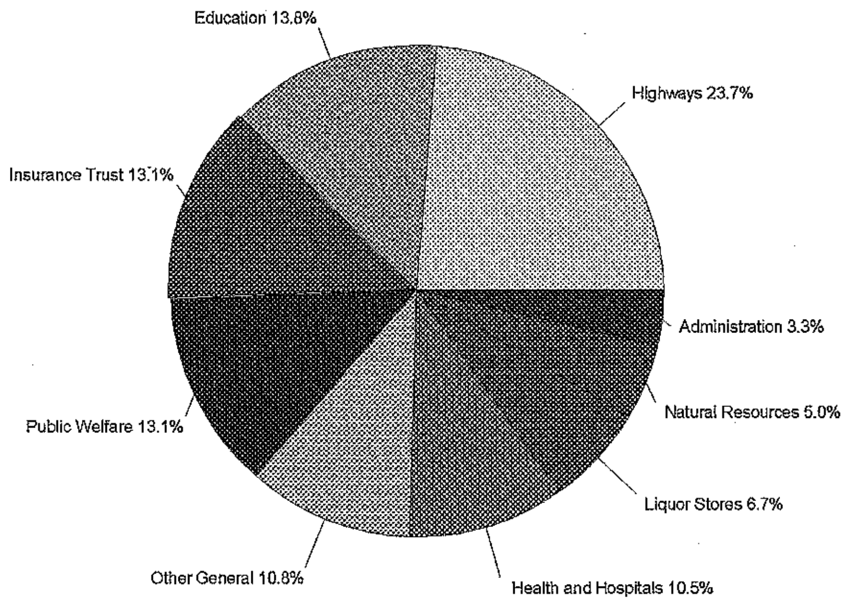
Areas of Fastest Spending Growth

Public welfare spending increased at the most rapid rate, followed by insurance trust, education, administration, and health and hospitals. Figures 13 and 14 on the following page illustrate the change in state spending priorities between 1952 and 1993. Underlying data can be found in Tables 13 and 14 in the appendix. The real per-capita rate of increase for each of these areas was the following:

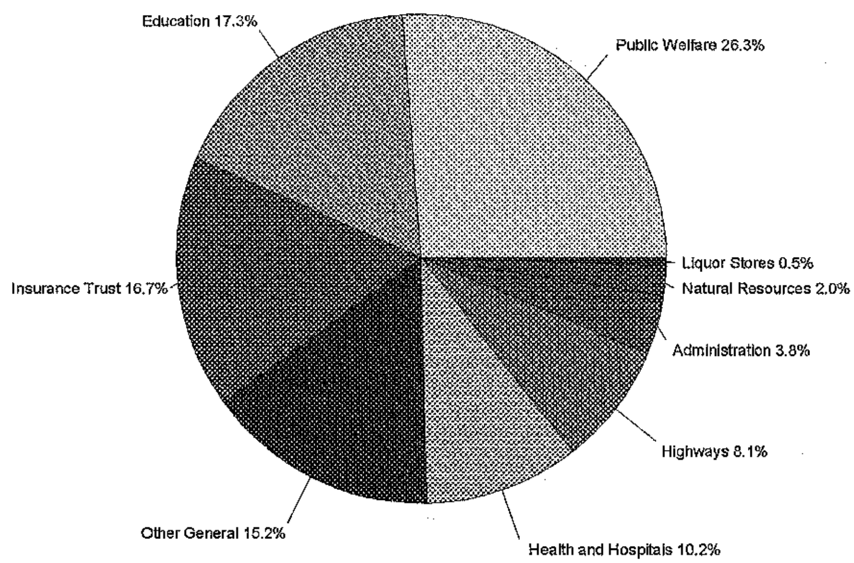
- Public welfare, up 1,008 percent;
- Insurance trust, up 602 percent;
- Education, up 588 percent;

Figures 13 and 14
Composition of State Government Spending

1952



1993



- Administration, up 524 percent; and
- Health and hospitals, up 436 percent.

Spending on public welfare rose from $1.4 billion in 1952 to $137 billion in 1993, doubling its share of total state spending. Spending on education rose almost as rapidly, from $1.5 billion to $90 billion, increasing its share of state spending from 13.8 percent to 17.3 percent.

The rise in welfare spending was principally driven by three factors: the obligation of states to help fund federal Great Society programs passed in the 1960s; rising health care costs for the poor; and generous benefit levels and lenient enforcement of eligibility standards.[16]

Education spending during this period was driven by several factors, including enrollment growth; growth of alternative employment opportunities for women following World War II; rapid unionization of public school teachers during the 1960s; and a nationwide effort starting in the 1950s to improve the quality of American schools following the Soviet launch of the first manned space craft.[17]

Public Spending on Elementary and Secondary Education, 1950 - 1990

Year	Expenditures, in 1990 dollars, adjusted for inflation
1950	$ 4.7 billion
1960	12.5 billion
1970	34.9 billion
1980	87.6 billion
1990	204.8 billion

Source: U.S. Department of Education, National Center for Education Statistics.

State spending on education increased faster than the overall rate of increase in school spending as state elected officials responded to calls for property tax relief and, more recently, "equalization" of spending by local school districts.[18] As a result, state tax revenues accounted for a growing share of local school spending, rising from 39.8 percent in 1950 to 47.3 percent in 1991.

Areas of Slow Spending Growth

Spending by state governments from 1952 to 1993 grew most slowly, after adjusting for inflation and population growth, in three areas:

- Natural resources, up 121 percent;
- Highways, up 88 percent; and
- Liquor stores, down 60 percent.

Spending on highways fell, as a percentage of state budgets, largely because the federal government expanded its role in highway funding following enactment in 1956 of the Federal-aid Highway Act. Under the Act and its subsequent amendments, the federal government provided matching funds on a 90/10 basis to state funds. Subsequent legislation expanded federal authority to fund bridge rehabilitation and replacement, and road resurfacing and rehabilitation programs.[19] This helps to explain the dramatic drop in highway spending from 23.7 percent of all state spending in 1952—the largest single category of spending—to just 8.1 percent in 1993, the sixth largest category of spending.

Spending on natural resources also fell relative to other areas of spending as the federal government expanded its role and funding into this area. Liquor stores, finally, fell in real per-capita terms as well as relative to other spending as more states privatized the sale of liquor. Seventeen states are still so-called "control states," where state-run liquor stores maintain legal monopolies over the retail sales of alcoholic beverages.

Winners and Losers

The shift in spending priorities that occurred at the state level was similar to the shift we observed in spending by all levels of government. State spending on public welfare, education, and health and hospitals between 1952 and 1993 rose from 37.4 percent of total spending to 53.8 percent. Spending on highways, natural resources, and "other general services" fell from 39.5 percent of total spending to 25.3 percent. As was the case with spending by all levels of government, benefits increasingly went to particular individuals who qualify for public benefits, not the general taxpaying public.

> Real per-capita state spending grew 54.1 percent from 1980 to 1993. State spending rose from 6.5 percent of gross domestic product in 1980 to 8.3 percent in 1993.

D. State Spending from 1980 to 1993

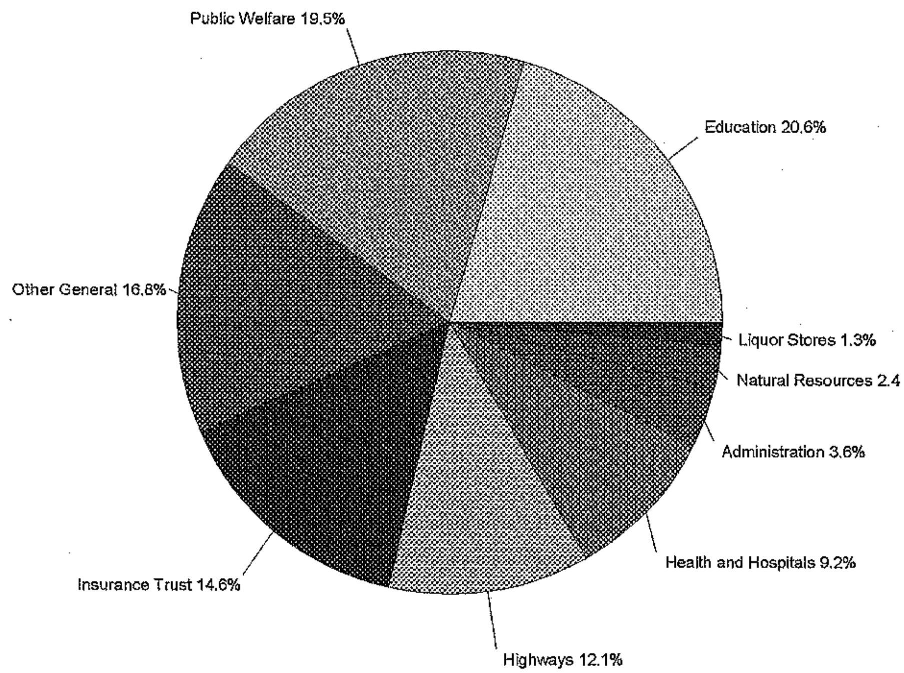
Between 1980 and 1993, annual state expenditures increased over 200 percent, from \$170.9 billion to \$521.7 billion. Adjusted for inflation and population growth, real per-capita spending grew 54.1 percent. State spending rose from 6.5 percent of gross domestic product in 1980 to 8.3 percent in 1993.

Changing Spending Priorities

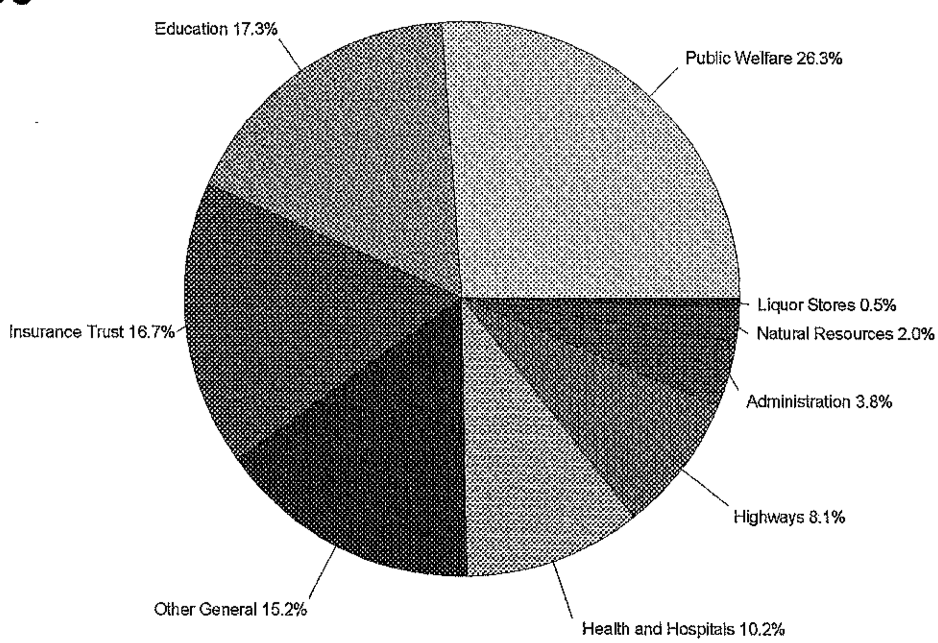
Public welfare spending again increased most dramatically, followed by insurance trust, health, and administration. Figures 15 and 16 on the following page illustrate the change in state spending priorities between 1980 and 1993. Underlying data can be found in Tables 15 and 16 in the appendix. Rates of spending growth, adjusted for inflation and population growth, were:

Figures 15 and 16
Composition of State Government Spending

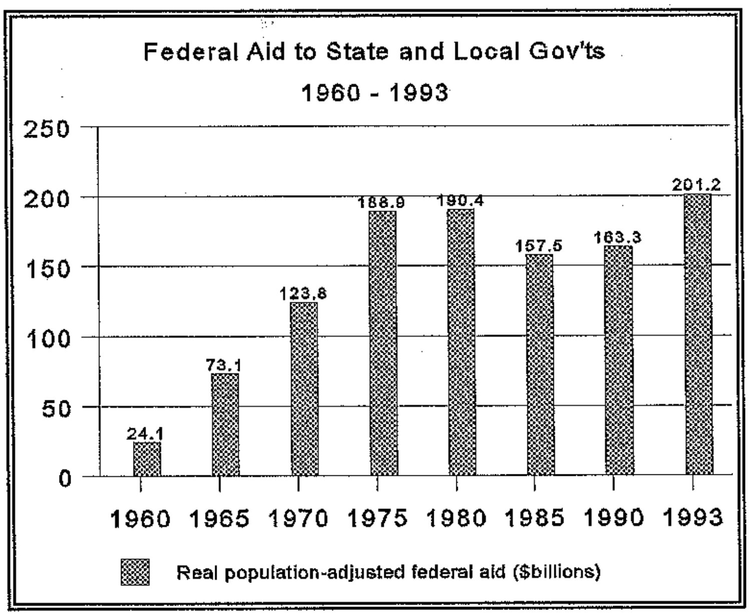
1980



1993



- Public welfare, up 108 percent;
- Insurance Trust, up 76 percent;
- Health and hospitals, up 71 percent;
- Administration, up 63 percent.



The slowest growing areas of spending, again controlling for inflation and population growth, were:

- Liquor stores, down 42 percent;
- Highways, up 3 percent;
- Natural resources, up 28 percent; and
- Education, up 29 percent.

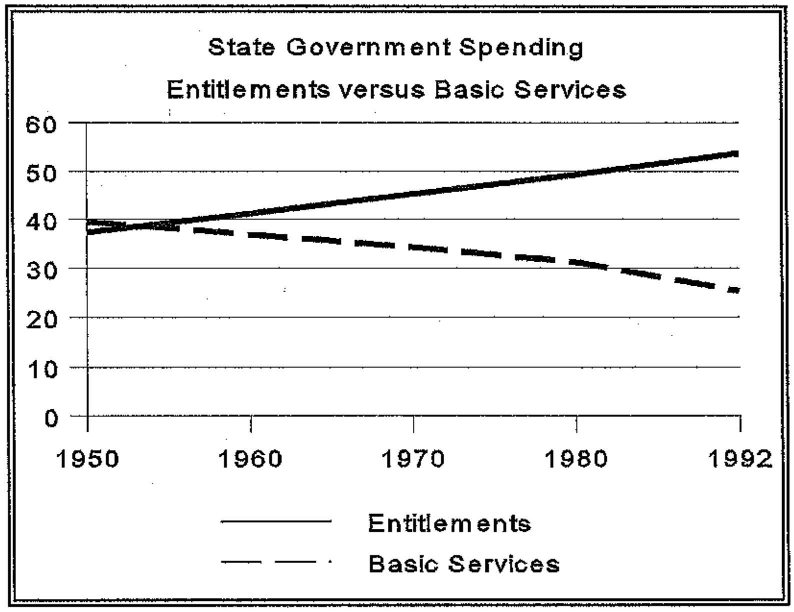
As was true of the long-term trend, growth in total state spending from 1980 to 1993 was so rapid that only one category of spending, state-owned liquor stores, grew more slowly than inflation and population growth. The slow-down in spending growth observed for all levels of government during the 1980s was not experienced at the state level.

Growth in spending on public welfare greatly outpaced spending on any other program, resulting in public welfare overtaking education as the largest single category of spending. Welfare spending rose from 19.5 percent of state spending in 1980 to 26.3 percent in 1993, while spending on education fell from 20.6 percent to 17.3 percent.

Federal Aid to State and Local Governments

State spending was able to grow faster than state revenues largely due to the growth of federal grants-in-aid to state and local governments. Such aid rose from $6.5 billion in 1960 to $88.7 billion in 1980, and $185.7 billion in 1993. Adjusted for inflation and population growth, real per-capita federal aid to state and local governments declined during the early 1980s but rose during the late 1980s and early 1990s to reach a record high in 1993. The chart above shows the trend since 1960.[20]

D. Summary and Conclusion



Earlier in this report, we observed strong trends during the 1960s and 1970s for overall government spending to shift toward entitlements and away from constitutionally required services and services that benefit everyone. That trend dramatically slowed, but did not stop, during the 1980s and first years of the 1990s.

We can now see that state governments did not contribute to changing the trends in spending during the 1980s and 1990s. As the chart on this page illustrates, the trend toward state spending on entitlements (defined in this case as public welfare, education, and health and hospitals) continued through the 1980s, while the trend away from basic services (natural resources, highways, and "other general spending") appears to have escalated during this period. Spending on entitlements rose from 37.4 percent of all state spending in 1952 to 49.3 percent in 1980 and 53.8 percent in 1993, while spending on basic services fell from 39.5 percent in 1952 to 31.3 percent in 1980 and 25.3 percent in 1993.

A new state spending trend that *did* emerge during the 1980s was a small move away from education spending, which rose dramatically relative to other spending priorities from 1950 to 1980 but then fell from 1980 to 1992. The change may be attributable to flat enrollment levels and lower rates of salary increases for teachers. After racing to make teacher salaries competitive with private-sector opportunities in the 1950s and 1960s, and then to fulfill teacher union demands during the 1960s and 1970s, state legislators in the 1980s may have begun to turn their attention to getting value for their investments. In real per-capita terms, however, spending on education still outpaced inflation and population growth by 29 percent between 1980 and 1993.

Part 4
Local Government Spending and Revenues
1950 - 1992

A. Local Government Revenues from 1950 to 1992

Between 1950 and 1992, annual local revenues increased at a faster rate than state revenues. Total local revenues, including revenues from federal and state governments, rose 3,900 percent, 591 percent adjusted for inflation, and 311 percent adjusted for both inflation and population growth. Total receipts rose from $16.1 billion in 1950 to $647.8 billion in 1992.

> From 1950 to 1992, total local government revenues rose 3,900 percent, 591 percent adjusted for inflation, and 321 percent adjusted for both inflation and population growth.

The three sources responsible for 81 percent of local tax revenue in 1950 were property taxes (43.7 percent), aid from state governments (26.2 percent), and utility taxes (11.2 percent).

By 1992, aid from state governments had displaced local property taxes as the largest single source of funds, with 30.3 percent of total revenues, and property taxes fell to second place with 26.5 percent. Charges and miscellaneous fees grew from 9.9 percent in 1950 to 20.1 percent in 1992 to become the third largest source of revenue. Utility taxes fell relative to other revenue sources, from 11.2 percent to 8.6 percent, while sales tax revenues rose from 3 percent to 5.2 percent of all receipts.

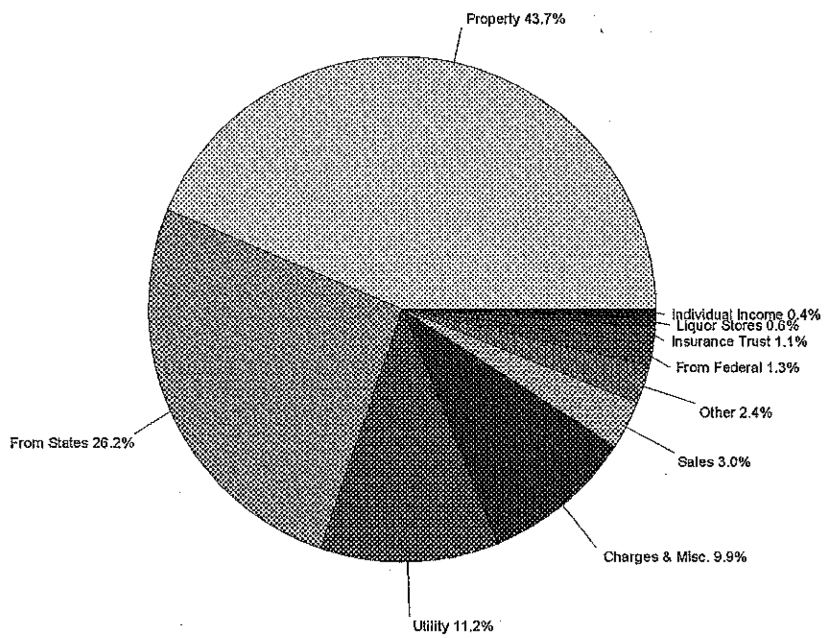
Figures 17 and 18 on the next page illustrate the change in sources of local revenues between 1950 and 1992. Supporting data are in Tables 17 and 18 in the appendix. The rates of increase for the four fastest growing local revenue sources, adjusted for inflation and population growth, were:

- Income taxes, up 1,911 percent;
- Insurance Trust, up 911 percent;
- From federal government, up 876 percent; and
- Charges and miscellaneous, up 731 percent.

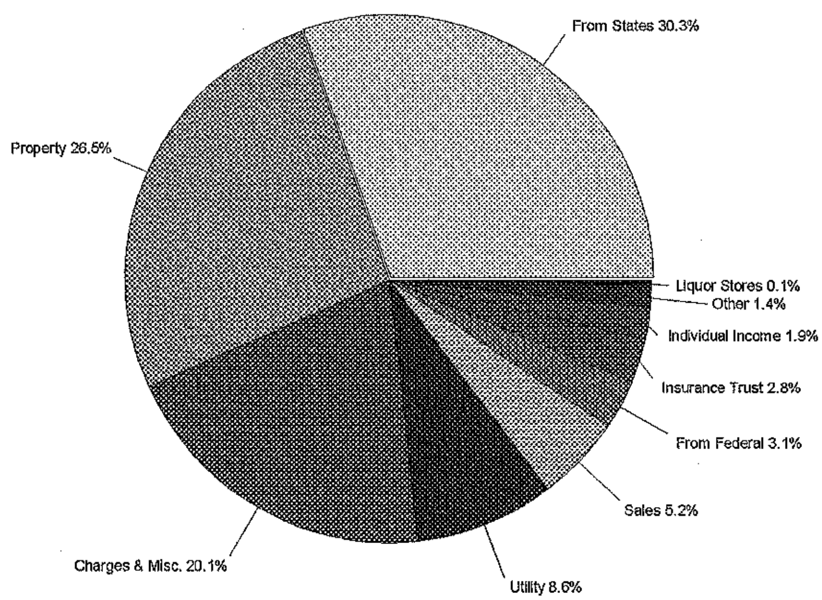
The slowest growing sources of revenues for local governments during this period were:

Figures 17 and 18
Composition of Local Government Revenues

1950



1992



Percentage of Local Government Budgets Funded by State Aid, 1992

Highest Levels of State Aid

New Mexico	51.7
West Virginia	46.0
Delaware	45.5
Arkansas	44.3
California	44.3
Wisconsin	42.7
Kentucky	42.6
Idaho	41.4
North Carolina	41.0
Washington	40.0

Lowest Levels of State Aid

Colorado	27.6
Texas	27.5
Georgia	27.3
Kansas	27.1
Nebraska	26.7
Oregon	26.5
Maryland	26.1
Rhode Island	25.8
South Dakota	23.1
New Hampshire	12.5

Source: Department of Commerce, Bureau of the Census; calculations by The Heartland Institute.

- Liquor stores, down 40 percent;
- Other taxes, up 143 percent;
- Property taxes, up 149 percent; and
- Utility taxes, up 213 percent.

Total local government revenues grew so rapidly between 1950 and 1992 that only the slowest growing revenue source, liquor stores, recorded a negative real per-capita rate of growth during this period. Property taxes more than doubled in real, per-capita terms, helping to explain the popularity of calls for property tax relief, yet even they were one of the slowest growing revenue sources for local governments. The rate of growth of local income taxes, at nearly 2,000 percent, was dramatic, but few local governments relied on them: they accounted for just 0.4 percent of total revenues in 1950, and 1.9 percent in 1992.

Total state aid to local governments rose from $4.2 billion in 1950 to nearly $200 billion in 1992, a rate of growth that exceeded inflation and population growth by 375 percent. Different state governments returned different amounts to local governments. In 1992, state funding made up 45 percent or more of local budgets in New Mexico, West Virginia, and Delaware. At the other extreme, local governments in New Hampshire, South Dakota, and Rhode Island received 26 percent or less of their budgets from the state. (See table on this page.)

Aid from the federal government also grew rapidly between 1950 and 1992—876 percent after inflation and population growth—but still accounted for only 3.1 percent of total revenues in 1992.

Another small but rapidly growing source of local revenues was tobacco taxes. Total local tobacco revenues increased from $38 million in 1963 to $182 million in 1995, an increase of nearly 400 percent.[21] The number of local jurisdictions collecting tobacco taxes rose from 225 in 1963 to 451 in 1995. Growing reliance on tobacco taxes appears to be part of a larger trend, noted earlier, by local governments to rely on their own sales taxes.

In summary, from 1950 to 1992, local governments dramatically increased their revenues relative to inflation and population growth. **Property taxes** fell from nearly half of total revenues to just over one-quarter, to be replaced primarily by increased **aid from state governments**, and **charges and miscellaneous fees**. While revenues from individual income taxes and the federal government rose rapidly during this period, these two sources combined accounted for just 4.0 percent of local revenues in 1992.

B. Local Government Revenues from 1980 to 1992

Between 1980 and 1992, annual local revenues increased 151 percent, from $258.3 billion to $647.8 billion. After adjusting for inflation and population growth, the increase was 31.6 percent. In other words, local government revenues outpaced inflation and population growth by about one-third during the 1980s and first years of the 1990s. On its face, this would seem to contradict claims that local governments were financially "hard pressed" during the 1980s.

> Local government revenues outpaced inflation and population growth by about one-third during the 1980s and first years of the 1990s.

The three largest sources of revenue at both the beginning and end of this period were state aid, local property taxes, and charges and miscellaneous fees. Figures 19 and 20 on the following page illustrate the change in local taxes between 1980 and 1992. Data can be found in Tables 19 and 20 in the appendix.

The fastest growing revenue sources during this period, after adjusting for inflation and population growth, grew at the following rates:

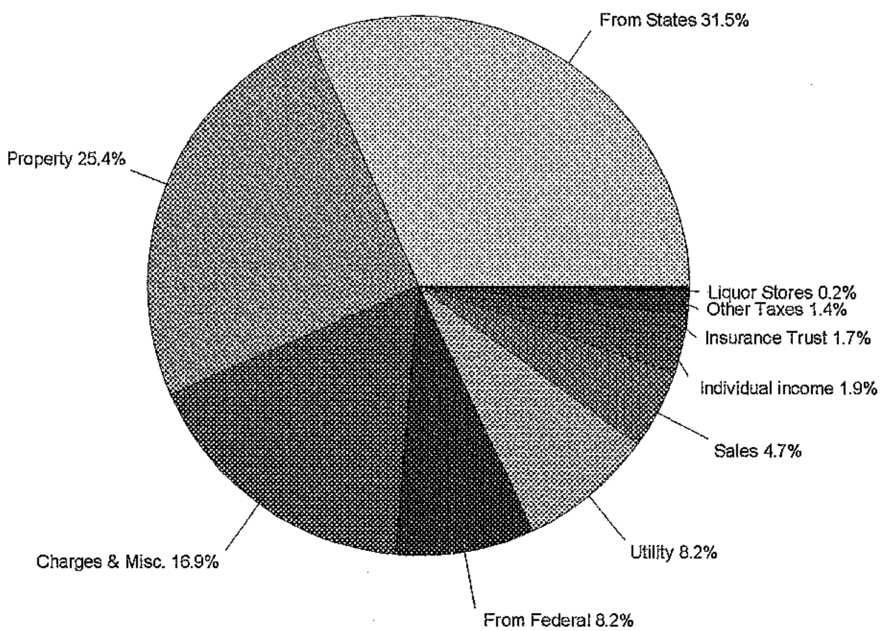
- Insurance Trust, up 120 percent;
- Charges and miscellaneous fees, up 57 percent;
- Sales taxes, up 45 percent; and
- Utility taxes, up 38 percent.

Growth rates for the slowest growing revenues sources during this period, again adjusted for inflation and population growth, were:

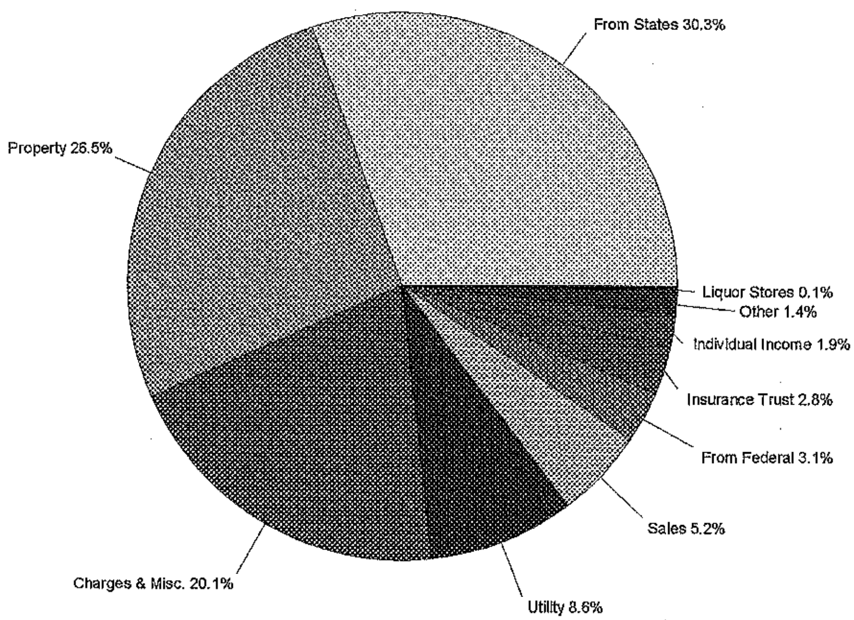
- Aid from the federal government, down 50 percent.
- Liquor stores, down 34 percent;

Figures 19 and 20
Composition of Local Government Revenues

1980



1992



- Aid from state governments, up 27 percent;
- Other Taxes, up 32 percent; and
- Personal income taxes, up 32 percent.

The real per-capita decrease in aid from the federal government is in striking contrast to the long-term (1950 - 1992) increase of nearly 900 percent. Similarly, the relatively slow rate of growth of state aid to local governments, relative to other revenue sources, marks a departure from the long-term trend. Federal aid fell from 8.2 percent of local revenues in 1980 to 3.1 percent in 1992, while state aid fell from 31.5 percent to 30.3 percent.

The discussion of federal aid to state and local governments in the previous section of this report noted the decline in real per-capita federal aid during the 1980s, but also reported a significant increase during the first few years of the 1990s. Some of that increase occurred in 1993, one year after the final year for which we have complete data on local revenues. But it is also likely that state governments benefitted more from increasing federal aid in the early 1990s than did local governments. This would be the case since much of the federal aid was earmarked for welfare and health programs administered by state, not local, governments.

> From 1980 to 1992, local governments came to rely more heavily on property taxes, charges and miscellaneous fees, and general sales taxes.

Due partly to the decline in federal and state aid relative to other revenue sources, local governments came to rely more heavily on property taxes (rising from 25.4 percent to 26.5 percent of total revenues), charges and miscellaneous fees (rising from 16.9 percent to 20.1 percent), and general sales taxes (rising from 4.7 percent to 5.2 percent). Revenue from utility taxes also rose slightly relative to other sources of revenue, from 8.2 percent to 8.6 percent of all revenues.

Closer examination of sales tax revenues reveals that large cities are approximately twice as reliant on sales taxes as municipalities in general, averaging about 10 percent of their total revenues from this source instead of 5 percent. While local governments as a group were becoming more reliant on sales taxes during the 1980s, the largest cities in the U.S. were becoming *slightly less* reliant on this revenue source. General sales taxes fell from an average of 10.1 percent of big city budgets in 1980 to 9.8 percent in 1992, a decrease of 3.0 percent. Only five major cities increased their reliance on general sales taxes, while ten reduced their reliance. (See table on the next page.)

To summarize, local revenues from 1980 to 1992 showed four major trends:

Sales and Gross Receipts Taxes as Percent of Total Revenues 1980 - 1992

Cities	1980	1992	% change
New York	9.1	7.6	-15.6
Los Angeles	11.0	10.8	- 1.5
Chicago	17.1	18.9	11.0
Houston	18.7	19.9	6.6
Philadelphia	0.2	2.1	920.5
San Diego	16.7	13.6	-18.6
Detroit	2.7	2.2	-19.4
Dallas	18.5	14.7	-20.9
Phoenix	18.4	17.1	- 7.3
San Antonio	5.2	6.6	26.0
San Jose	19.6	19.0	- 3.1
Baltimore	2.7	2.4	-12.3
Indianapolis	0.7	2.1	190.2
San Francisco	7.3	6.8	- 6.1
Jacksonville	3.7	2.6	-29.7
Average	10.1	9.8	- 3.0

Source: Bureau of the Census; calculations by The Heartland Institute.

- **Total revenues** outpaced inflation and population growth by one-third.

- Real per-capita **state aid** to local governments grew 27 percent, enough to almost keep pace with total local government spending but not enough to sustain the previous trend toward increasing reliance on state aid.

- Real per-capita **federal aid** fell almost by half, and as a percentage of total revenues fell from 8.2 percent in 1980 to 3.1 percent in 1992. Increasing federal aid to state governments in 1992 and 1993 may not have reached local governments.

- To sustain its rapid rate of growth without similar increases in state or federal funds, local governments increased their reliance on **property and sales taxes**. In the case of property taxes, this reversed a long-term trend that had seen reliance on this revenue source fall from 44 percent in 1950 to 25.4 percent in 1980.

C. Local Government Spending from 1950 to 1992

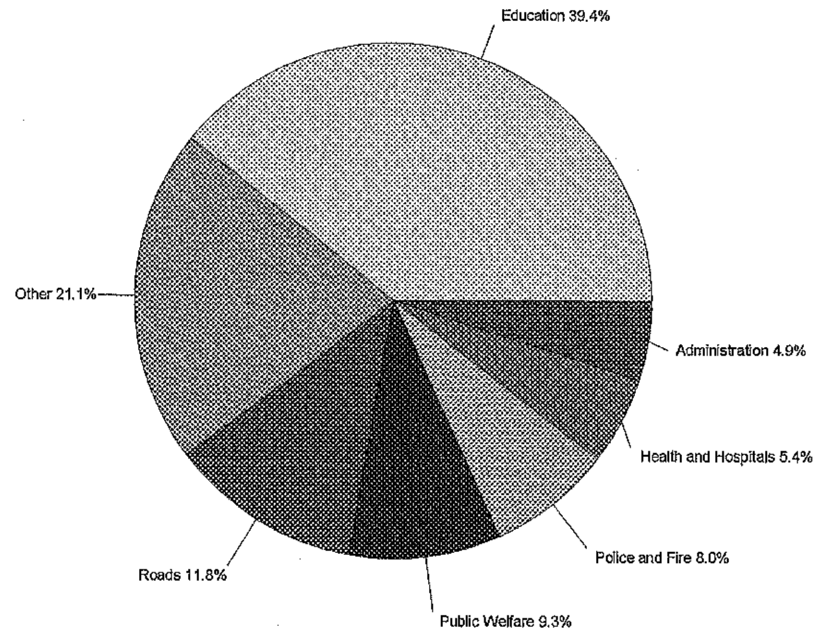
Between 1950 and 1992, annual local expenditures increased about 3,800 percent, from $14.7 billion to $570.2 billion. Adjusted for inflation and population growth, the rate of increase was 295 percent; put another way, real per-capita local government spending nearly quadrupled from 1950 to 1992.

Census Bureau data breaks local government spending into only seven categories. In 1950, education, "other," and roads were the three largest categories of spending, accounting for 72.3 percent of total spending. In 1992, education and "other" had increased their shares of total spending while the share of spending devoted to roads fell by over half. Spending on health and hospitals rose to replace roads as the third largest category of spending.

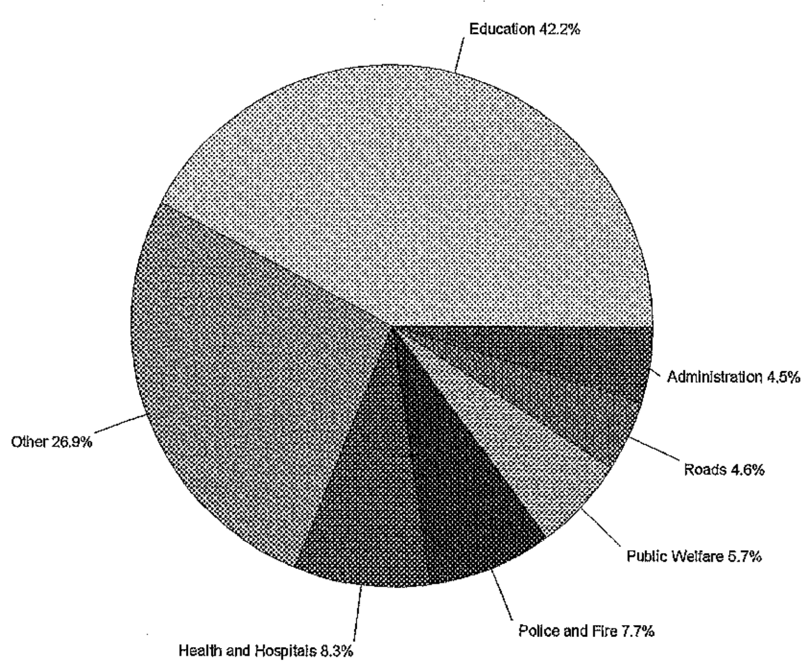
Figures 21 and 22 on the following page illustrate the change in local spending priorities between 1950 and 1992. Underlying data can be found in Tables 21 and 22 in the appendix. The fastest growing categories of spending, and their rate of growth in real per-capita dollars, were:

Figures 21 and 22
Composition of Local Government Spending

1950



1992



- Health and hospitals, up 503 percent;
- "Other," up 404 percent;
- Education, up 323 percent; and
- Police and fire, up 282 percent.

> Real per-capita spending on welfare more than doubled during this period, while education spending more than quadrupled and spending on health and hospitals increased six-fold.

The slowest growing areas of spending, again controlled for inflation and population growth, were:

- Roads, up 54 percent;
- Welfare, up 142 percent; and
- Administration, up 266 percent.

Spending once again was growing so rapidly that even the slowest growing categories of spending saw substantial rates of growth. Real per-capita spending on welfare more than doubled during this period, while education spending more than quadrupled and spending on health and hospitals increased six-fold.

Comparing spending on entitlement programs versus constitutionally required services and services that benefit all citizens is difficult at the local level due to the small number of categories of spending and the large size of the "other" spending category (about a quarter of all spending). If we take spending on health and hospitals, education, and public welfare to be examples of entitlement spending, and police and fire and roads as examples of basic services, we find that spending on entitlements rose only slightly, from 54.1 percent in 1950 to 56.2 in 1996, while spending on basic services fell from 19.8 percent to 12.3 percent.[22]

In summary, local government spending rose at nearly four times the rate of inflation and population growth from 1950 to 1992. Areas of fastest spending growth were health and hospitals, "other," and education, while spending on public welfare and roads grew most slowly. The previously observed trend away from basic services and toward entitlements occurred to a lesser degree at the local government level, and was most apparent as a decline in share of spending by basic services, not as a growing share held by entitlement spending.

D. Local Government Spending from 1980 to 1992

Between 1980 and 1992, annual local expenditures increased about 153 percent, from $225.3 billion to $570 billion. Adjusted for inflation and population growth, the increase was 32.8 percent. This is slightly more than the 31.6 percent increase reported for real per-capita local government revenues. The difference was largely funded by the acquisition of debt.

The largest categories of spending in both 1980 and 1992 were education and "other." Combined, these categories accounted for 69.9 of all spending in 1980 and 69.1 percent in 1992. Figures 23 and 24 on the following page illustrate the change in local spending priorities between 1980 and 1992. Underlying data can be found in Tables 23 and 24 in the appendix.

The fastest growing areas of local government spending during this period, and the percentage change adjusted for inflation and population growth, were the following:

- Health and hospitals, up 50 percent;
- Administration, up 46 percent;
- Public welfare, up 39 percent; and

> The fastest growing areas of local government spending from 1980 to 1992 were health and hospitals, administration, and public welfare.

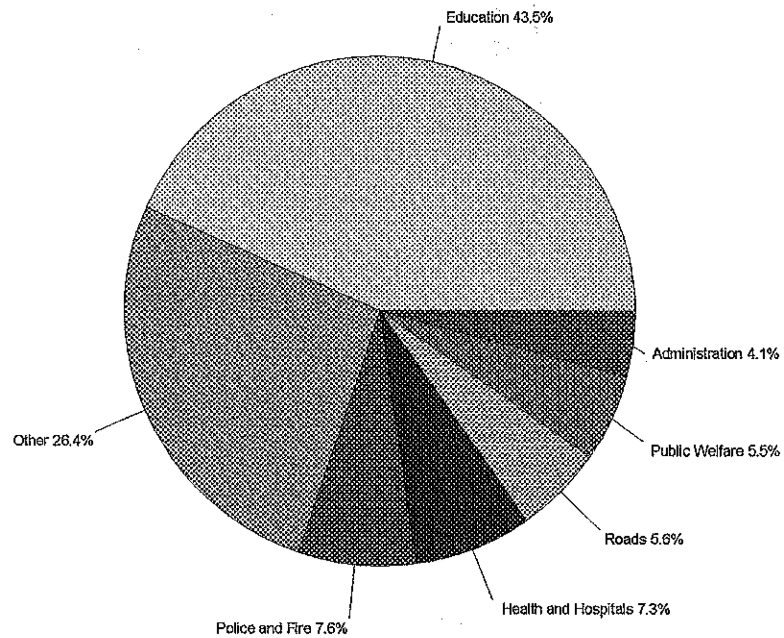
The slowest growing areas of local government, again with increases adjusted for inflation and population growth, were:

- Roads, up 9 percent;
- Education, up 29 percent; and
- Police, up 35 percent.

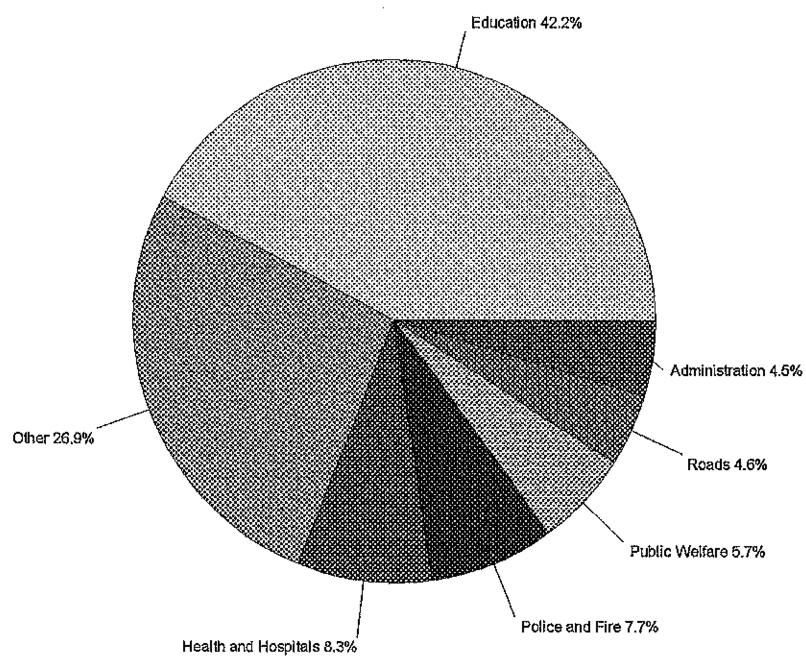
Education spending fell from 43.5 percent of local spending to 42.2 percent, reversing the long-term trend in this area. (Real per-capita spending nevertheless increased by nearly one-third.) A decline in education's share of total spending by all levels of government and state governments also was observed earlier. Road spending fell from 5.6 percent of local spending to 4.6 percent, continuing a downward spiral that started with local governments devoting 11.8 percent of their budgets to roads in 1950.

Figures 23 and 24
Composition of Local Government Spending

1980

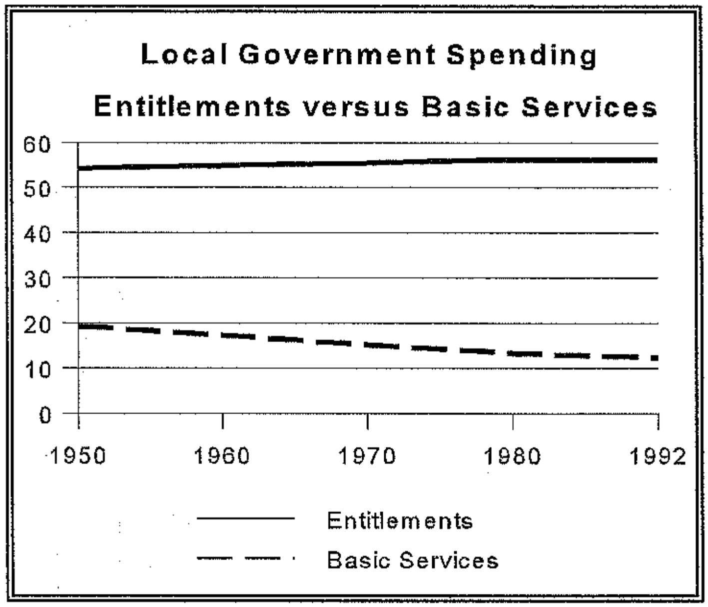


1992



Spending on public welfare rose from 5.5 percent to 5.7 percent of all spending, moving in the opposite direction of the trend from 1950 to 1992. This small rise relative to other spending may represent the end of a long experiment in "federalizing" social welfare programs. During the 1980s and 1990s, considerable discussion took place about the appropriate role of the federal government in setting welfare policies. Governors were given greater discretion to set eligibility standards and use federal funds to finance welfare-to-work programs. One consequence of these changes in policy may be that local governments faced new responsibilities for administering welfare programs or for caring for persons no longer eligible for federal or state aid programs.

Local government spending on entitlement programs, as previously defined, remained almost unchanged from 1980 to 1992, falling slightly from 56.3 percent in 1980 to 56.2 percent in 1992. Spending on basic services declined from 13.2 percent of total spending in 1980 to 12.3 percent in 1992. This suggests that all of the (small) increase in local government spending on entitlements relative to total spending that was observed for the long-term period occurred prior to 1980. The trend away from basic services continued through the 1980s at a somewhat slower rate than during the preceding decades.



E. Summary and Conclusion

Real per-capita local government revenues and spending grew dramatically since 1950 and continued to outpace inflation and population growth in the 1980s. Real per-capita revenues grew 311 percent between 1950 and 1992, with increases in state aid, charges and miscellaneous charges, and utility taxes most responsible for the increase.

During the 1980s, education dominated the next largest category of spending by a nearly two-to-one margin. After growing relative to other areas of local government spending during the 1950s, 1960s, and 1970s, however, education spending fell slightly during the 1980s even though real per-capita spending on education grew by one-third.

A weak trend toward entitlement spending and away from constitutionally required services and services that benefit everyone was observed for local government spending during the period from 1950 to 1992. Entitlement spending remained almost unchanged, as a percentage of total local government spending during the 1980s, while spending on basic services continued to decline, though at a slower rate than in previous decades.

Part 5
State Revenues and Spending
1992 - 1996

Examining preliminary data on state taxes and spending from 1992 to 1996 gives us some insight into whether the trends that occurred during the 1980s and first few years of the 1990s have continued. Incomplete information makes it difficult to construct a complete picture of these changes.[23] We focus on changes in state revenues between 1993 and 1995; state spending between 1992 and 1995; and changes in specific state tax rates from 1994 to 1996.

A. State Government Revenues from 1993 to 1995

Between 1993 and 1995, total state revenues increased 13.6 percent, from $353.5 billion in 1993 to $401.5 billion in 1995. Adjusted for inflation and population growth, the increase was 4.8 percent over the two-year period.[24] Figures 25 and 26 on the next page illustrate the change in state revenue sources between 1993 and 1995. Underlying data can be found in Tables 25 and 26 in the appendix.

> Not only did state revenues grow faster than inflation and population growth from 1993 to 1995, they also grew faster than the average rate of increase during the preceding 12-year period.

The moderation in growth in state revenues that occurred between 1980 and 1993 apparently did not continue past 1993. At approximately 2.25 percent per year, state revenues grew faster between 1993 and 1995 than they grew during the preceding 12-year period. As reported earlier, state revenues grew 22 percent from 1980 to 1993.

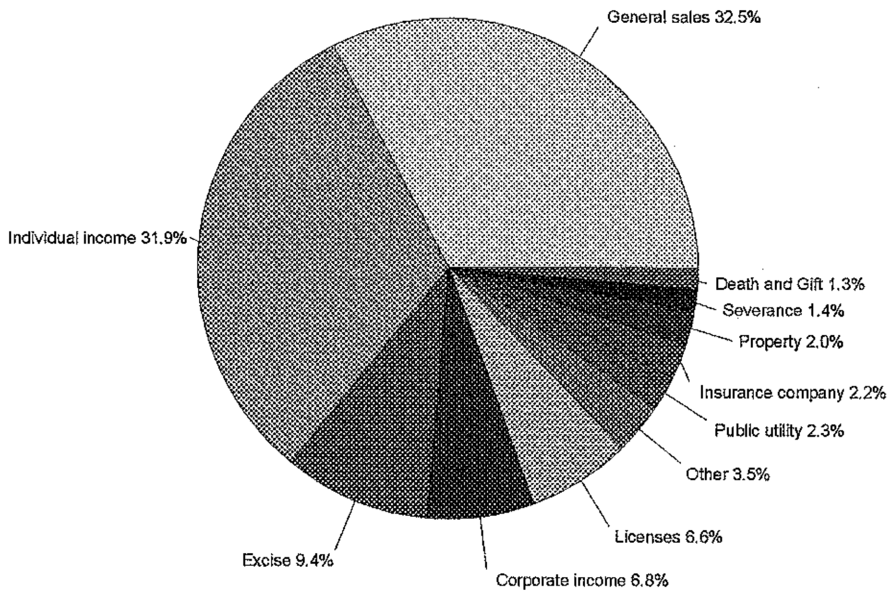
Changing Revenue Sources

The fastest growing sources of revenue from 1993 to 1995, and their increases adjusted for inflation and population growth, were the following:

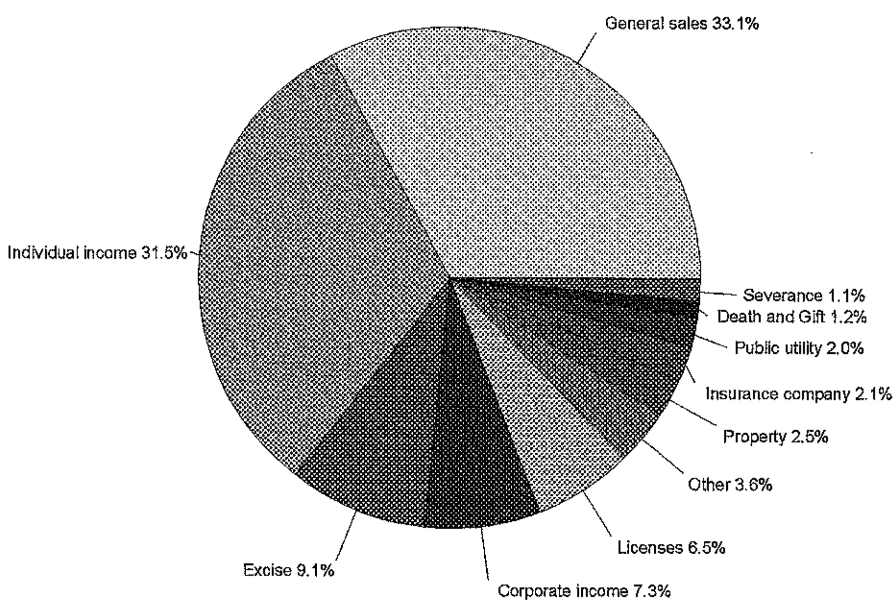
- State property taxes, up 33 percent;
- Corporate income taxes, up 11 percent;
- "Other" taxes, up 8 percent; and
- General sales taxes, up 7 percent.

Figures 25 and 26
Composition of State Government Revenues

1993



1995



The slowest growing sources of revenue, and their increases (again adjusted for inflation and population growth) were the following:

The shift away from individual income taxes may be small, but it could mark the end of rising reliance on income taxation by state governments.

- Severance taxes, down 15 percent;
- Utility taxes, down 9 percent;
- Death and gift taxes, down 4 percent; and
- Insurance, up .5 percent.

State property tax revenues increased from 2.0 percent of total state revenue in 1993 to 2.5 percent in 1995, reversing both the long-term trend (1950 - 1993) and the trend observed during the 1980s. (Real per-capita state property taxes fell 39 percent from 1980 to 1993.) Nevertheless, property taxes continue to be a minor revenue source for states. The increase in corporate income taxes also reversed the trend from the 1980s, when corporate income taxes fell from 9.1 percent of total receipts in 1980 to 6.9 percent in 1993.

The trend toward greater reliance on general sales taxes continues a pattern observed during the 1980s as well as the long-term period. The declining reliance on public utility taxes continues a trend from the 1980s, but not seen in the long-term period.

Individual income taxes fell slightly relative to other revenue sources, from 31.9 percent of total spending to 31.5 percent. This shift away from individual income taxes may be small, but this is a new trend for state governments (though not for all levels of government combined) and it could mark the end of rising reliance on income taxation by state governments.

Excise taxes rose .9 percent faster than inflation and population growth, but fell from 9.4 percent of all state revenues in 1993 to 9.1 percent in 1995. This continues the long-term trend (excise taxes were 27.2 percent of state revenues in 1950) as well as the trend of the 1980s (excise taxes were 10.9 percent in 1980). "Unpacking" this category reveals that real per-capita taxes on tobacco rose 10.2 percent from 1993 to 1995, the third largest increase behind corporate income taxes and state property taxes. Motor fuel taxes fell 0.3 percent, and alcohol taxes fell 7.7 percent, after controlling for inflation and population growth.

B. State Government Spending from 1992 to 1995

To obtain comparable data on state spending in the years since 1992, we have relied on the annual reports of the National Association of State Budget Officers (NASBO).[25] This is a very limited database. Spending is divided into just seven categories, and the "all others" category amounts to fully a third of total spending. These categories of spending are not comparable to those used earlier. The reader should note that the spending estimates in this section also cannot be meaningfully compared to the revenue estimates presented in Section A.

Spending by state governments rose from $596 billion in 1992 to $721 billion in 1995, a real per-capita increase of 7.3 percent over a three-year period. The three largest areas of spending in 1992 were Medicaid (17.1 percent), education (21.4 percent), and "all others" (32.1 percent). The same three categories topped the list of expenditures in 1995.

Spending by state governments rose from $596 billion in 1992 to $721 billion in 1995, a real per-capita increase of 7.3 percent over a three-year period.

Figures 27 and 28 on the next page illustrates the change in state spending priorities between 1992 and 1995. Underlying data can be found in Tables 27 and 28 in the appendix. The fastest growing areas of spending, and their real per-capita increases, were:

- Medicaid, up 20 percent;
- "All others," up 11 percent;
- Corrections, up 13 percent; and
- Education, up 5 percent.

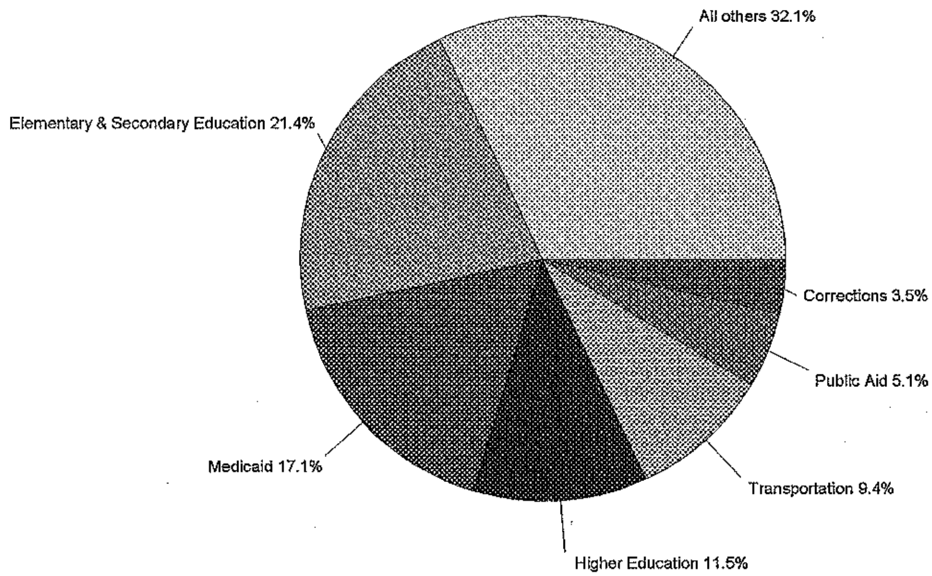
The slowest growing categories of spending were:

- Public aid, down 16 percent;
- Higher education, down 4 percent; and
- Transportation, down 0.2 percent;

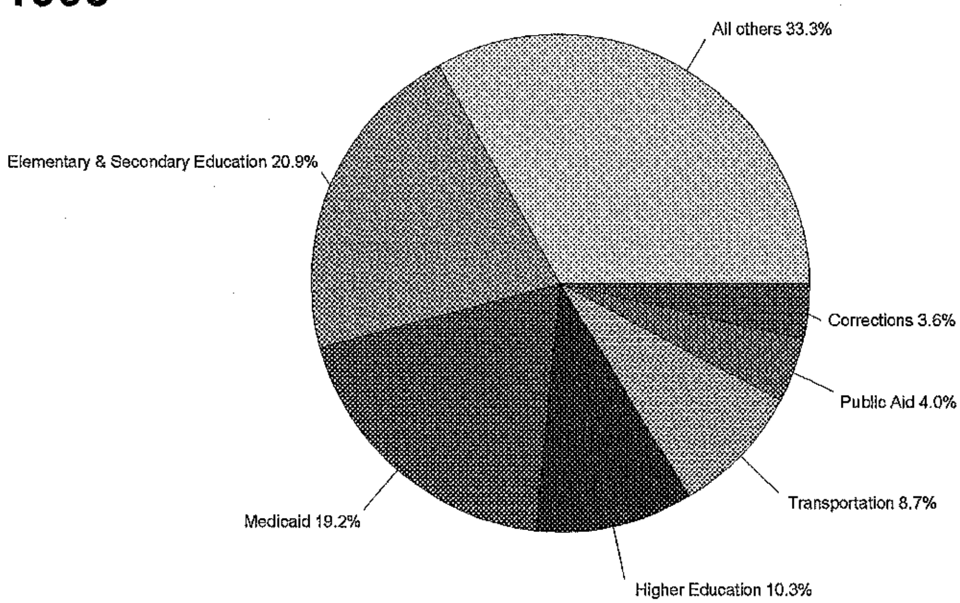
Of the seven categories of spending, three increased their share of total spending. Medicaid, a form of public aid spending, grew from 17.1 percent of total state spending in 1992 to 19.2 percent in 1995. Nevertheless, evidence emerged in 1995 that spending growth in this area was slowing. From 1994 to 1995, Medicaid spending grew 5.1 percent, less than the 7.2 increase in total spending and considerably less than the 10.7 percent increase that occurred between 1993 and 1994. In its 1995 annual report on state expenditures, NASBO expressed relief at finally reversing a 30-year trend:

Figures 27 and 28
Composition of State Government Spending by Function

1992



1995



After a long period of experiencing double-digit increases, states appear to have successfully employed cost containment measures to curb Medicaid costs in fiscal 1995. The growth rate is down considerably from the increases experienced a few years ago, due to federal mandates being fully phased in and states' cost containment efforts. States' active pursuit of solutions to their latest "budget buster" has finally resulted in Medicaid growth which is below overall growth in state spending.[26]

State spending on public aid fell from 5.1 percent to 4.0 percent of all spending. Combining NASBO's Medicaid and public aid lines produces a total public welfare category that was 22.2 percent of state spending in 1992 and 23.2 percent in 1995. This small increase stands in strong contrast to the long-term trend revealed by Census Bureau data, showing public welfare spending rising from 13.1 percent of state spending in 1952 to 19.5 percent in 1980 and 26.3 percent in 1993.

From 1994 to 1995, state spending on public aid (excluding Medicaid) increased by just 0.8 percent. From 1994 to 1995, 34 states reported spending reductions, and spending actually *fell* by 0.6 percent.

Between 1993 and 1994, according to NASBO, 21 states reported a decline in spending on Aid to Families with Dependent Children (AFDC), the principal state public aid program. During this period, state spending on public aid increased by just 0.8 percent. Between 1994 and 1995, 34 states reported spending reductions, and spending actually *fell* by 0.6 percent.

Spending on corrections grew from 3.5 to 3.6 percent of state spending between 1992 and 1995, an increase NASBO attributes to a "tough on crime" public sentiment, mandatory sentencing laws, and court-imposed orders for relief of overcrowded prisons or improved prison conditions.[27] Spending on transportation fell from 9.4 percent of all spending to 8.7 percent, in step with a trend that we have traced all the way back to 1952. NASBO's "transportation" category is more broad than the Census Bureau's category of "roads," making comparisons impossible.

Spending on "all others" increased from 32.1 percent of all spending in 1992 to 33.3 percent in 1995. This category includes hospitals and other health programs, economic development, environmental projects, state police, juvenile institutions, parks and recreation, housing, and general aid to local governments.

According to NASBO, spending on elementary, secondary, and higher education fell relative to total state spending. Combining the categories, we see that total state spending on education fell from 32.9 percent of total spending in 1992 to 31.2 percent in 1995, continuing a trend that started during the 1980s after large increases in education spending during the 1960s and 1970s.

NASBO's method of grouping expenses does not allow us to track the trend toward or away from entitlement spending. However, the decline in education spending and public aid (relative to total spending), the slowing growth of Medicaid in the final year of the series, and rising spending on corrections suggest that this trend, which had slowed considerably during the 1980s, probably stopped and/or reversed direction in 1995.

States with the Highest General Sales Taxes, 1996

Rhode Island	7.00%
Mississippi	7.00
Washington	6.50
Nevada	6.50
Texas	6.25
Illinois	6.25
Connecticut	6.00
Florida	6.00
California	6.00
Michigan	6.00

Source: Tax Foundation. Note that many states allow counties and local governments to add to these rates.

C. State Tax Rates, 1994 - 1996

While we do not yet have revenue data for 1996, we do have good data concerning changes in state tax rates adopted in 1995 for the 1996 fiscal year.

General Sales Taxes

State general sales taxes raised $123.8 billion in 1994 and $132.7 billion in 1995. Their share of total state revenues increased from 32.5 percent to 33.1 percent. Michigan was the only state to increase a general sales tax rate during this period, increasing its rate 50 percent (from 4 percent to 6 percent) in exchange for property tax relief. The controversial plan, which also increased cigarette taxes by 50 cents a pack, is described in more detail below.

At 7 percent, Rhode Island and Mississippi had the highest state general sales taxes in the nation in 1996. Washington and Nevada followed at 6.5 percent. Minnesota, Utah, Georgia, and the District of Columbia reduced general sales tax rates between 1994 and 1996. Additional information about state sales taxes in 1994 and 1996 can be found in Table 29 in the appendix, and in the table above.

Individual Income Taxes

In a striking departure from the long-term (1950 - 1993) and short-term (1980 - 1993) trends, between 1994 and 1996 states began reducing their reliance on individual income taxes. Eight states cut marginal income tax rates in 1994 and 1995. Michigan and New Mexico cut tax rates in 1994; California, Connecticut, and Delaware followed with cuts in 1995; and Arizona, New Jersey, and New York cut their taxes in both years.

The situation in New Jersey is of particular interest. Governor Christine Todd Whitman took office in 1994 by pledging to cut the state's income tax rates by 30 percent over three years.

Upon winning the election, she became a conservative hero to many by cutting tax rates by the promised amount in two rather than three years.[28]

Because New Jersey's income tax receipts are earmarked for local property tax relief, the state will offer a good case study in whether or not reductions in state aid necessarily lead to higher local taxes. The cut made in 1995 apparently did not result in higher property taxes that year, according to an analysis by the New York-based Manhattan Institute.[29] It is too early to tell what the longer term results will be.

> In a striking departure from the long-term and short-term trends, between 1994 and 1996 states began reducing their reliance on individual income taxes.

On the spending side in New Jersey, Governor Whitman cut some $1.2 billion out of the 1996 budget. However, many of the savings appear to be the result of creative bookkeeping rather than actual belt-tightening.[30] The principal "savings" are:

- Paying retirees' medical benefits as current expenses rather than funding them in advance (savings: $279 million);
- Paying the fund the same amount for each employee rather than paying more for older employees and less for younger employees (savings: $318 million); and
- Assuming an annual inflation rate of 4 percent instead of 5 percent (savings: $125 million).

Combined, these bookkeeping changes amount to $955 million, or 80 percent of total spending cuts. The Governor defends the cuts as good business practices and says she would have made cuts elsewhere if she needed to. Nevertheless, she has been campaigning for higher cigarette taxes and various other narrow-based taxes and user fees to keep her budget balanced. It is not clear whether she will control spending sufficiently to avoid a general sales tax hike in 1997.

Corporate Income Taxes

State corporate income taxes raised $25.6 billion in 1994 and $29.2 billion in 1995. Corporate income taxes were responsible for a rising share of state budgets from 1993 to 1995, growing from 6.8 percent to 7.3 percent of all revenues, but this increase was apparently due to record levels of corporate profits, not to higher tax rates. In fact, five states reduced their corporate income tax rates in 1994: Arizona, Michigan, New Jersey, New York, and Pennsylvania. In 1995, Connecticut lowered its corporate income tax rate.

According to the Tax Foundation, during 1994 and 1995 nine states made changes to their corporate income tax *bases* that had the effect of lowering rates, while four (Iowa, Minnesota, Nebraska, and Rhode Island) increased taxes through changes to the base.

State Gasoline Taxes in 1996
(dollars per gallon)

High Gasoline Tax States

Connecticut	$0.380
Rhode Island	0.280
Montana	0.270
Nebraska	0.264
Idaho	0.250
Oregon	0.240
Nevada	0.240
Wisconsin	0.237
Maryland	0.235
Delaware	0.230

Low Gasoline Tax States

Indiana	$0.150*
Vermont	0.150
Michigan	0.150*
Pennsylvania	0.120
New Jersey	0.105
Wyoming	0.090
New York	0.080*
Alaska	0.080
Georgia	0.075
Florida	0.050

* These states also impose general sales taxes on gasoline. When included, Michigan and New York have above-average effective gas tax rates.

Source: Tax Foundation, October 1996.

The downward trend in corporate income tax rates and the proliferation of base reductions appear to be due to recently heightened competition among states for new businesses and business expansion.[31] Because of these cuts and reductions, corporate income tax revenues will probably fall as a share of state revenues when corporate profits return to their historic levels.

Motor Fuel Taxes

State governments raised $24.9 billion from motor fuel taxes in 1994 and $25.5 billion in 1995, but revenues from this source accounted for a declining share of state revenues from 1993 to 1995. State motor fuel tax rates in 1996 averaged 18.72 cents per gallon, a 2 percent increase from 1994. Rates ranged from a high of 38 cents per gallon in Connecticut to a low of 5 cents in Florida. (See table on this page for other outliers.)

States that increased their gasoline taxes most rapidly between 1994 and 1996 were West Virginia (32 percent), Connecticut (31 percent), Missouri (31 percent), and Idaho (14 percent). Three states cut their gasoline taxes: Tennessee (-6 percent), New Mexico (-23 percent), and Florida (-59 percent). See Table 29 in the appendix for more information.

Tobacco Taxes

In 1993, governments raised $12 billion by taxing cigarettes. Of that amount, $5.5 billion went to the federal government (24 cents per pack) and $6.2 billion went to state governments (28.6 cents per pack). The average total tax of 53 cents per pack was approximately 31 percent of the retail price of a pack of cigarettes.

"Cigarettes," according to Duke University economist W. Kip Viscusi, "are the most heavily taxed major category of consumer purchases. Relative to the purchase amount, tobacco products are subject to a higher tax rate than alcohol, three times the tax rate of gasoline, and over ten times the tax rate imposed on items such as utilities and automobiles."[32]

State tobacco taxes raised $6.2 billion in 1993, $6.6 billion in 1994, and $7.4 billion in 1995. Although this rate of increase was faster than the growth in overall state revenues (19.3 percent versus 13.6 percent), the share of state revenues raised from tobacco taxes remained at 1.8 percent. The average tax per pack in the U.S. was 29.05 cents in 1994 and 32.66 cents in 1996.

Nine states increased their taxes on cigarettes between 1994 and 1995, with Arizona posting the largest increase, going from 18 cents per pack to 58 cents for a 222 percent tax hike. (See table on this page.) Only one state, Nebraska, reduced its cigarette tax, from 37 cents to 34 cents per pack. Table 30 in the appendix has more information.

One of the most controversial tobacco tax increases occurred in March 1994, when Michigan voters approved Proposal A, a referendum that reduced property taxes in return for raising the general sales tax from 4 percent to 6 percent and increasing cigarette taxes by 50 cents per pack, from 25 cents to 75 cents. Proposal A passed with support from most of the state's business community, which opposed an alternative plan that would have raised corporate and individual income taxes.

States That Increased Cigarette Taxes, 1994 - 1996

State	% increase	Governor's Party
Arizona	222%	Republican
Michigan	200	Republican
Vermont	120	Republican
Idaho	56	Republican
Washington	51	Republican
South Dakota	43	Republican
Rhode Island	39	Democrat
Wisconsin	16	Republican
Connecticut	6	Republican
National average	12%	

Source: Tax Foundation, Heartland Institute calculations.

Republican Governor John Engler campaigned hard for Proposal A based on his long-standing desire to see the state's general sales tax (which was lower than that of most neighboring states) increased. The Michigan experience is important for two reasons. First, some observers claimed that it "opened the door" for other states to raise taxes on tobacco products, both because of the large size of the tax hike and because Michigan is a large Midwest state not known for having a liberal electorate. Governors and legislators in other states, who may have hesitated in the past to push for small increases in cigarette taxes, may now be emboldened to push for much larger increases.

Second, the Michigan decision involved a popular conservative governor who was willing to massively raise taxes on a specific product, apparently not believing that doing so contradicted his anti-tax rhetoric. This could indicate that conservative governors are willing to finance their (popular) income tax cuts by increasing taxes on (unpopular) tobacco products. *Indeed, the governors of eight of the nine states that raised tobacco taxes between 1994 and 1996 were Republicans.* However, only three of the nine states that increased cigarette taxes also cut income tax rates (Michigan, Connecticut, and Arizona).

Republican governors seeking ways to make up for revenue lost due to income tax cuts appear to be eyeing tobacco taxes. Maryland's governor has proposed doubling that state's current tax of 36 cents per pack to partially offset a cut in the income tax.[33] In December 1995, New Jersey Governor Whitman was "vowing to fight for a cigarette tax" hike of 25 cents per pack.[34] Local governments, too, are increasingly viewing tobacco as a revenue source: As reported earlier, total local tobacco revenues increased nearly 400 percent between 1963 and 1995, while the number of local jurisdictions collecting tobacco taxes nearly doubled.

> The governors of eight of the nine states that raised tobacco taxes between 1994 and 1996 were Republicans.

Smokers can take some comfort in the fact that many conservative Republicans have consistently opposed higher taxes on tobacco as part of their opposition to all tax increases. In New Jersey, for example, a newspaper report of Governor Whitman's support for higher cigarette taxes said "the political ramifications of raising a tax, even one that polls show the public supports, has shattered GOP unity and stalled negotiations on the charity care program, which will expire at year's end without legislative action." Democrats were refusing to vote for the higher tax, too.

Alcohol Taxes

Governments at all levels raise approximately $18 billion per year through taxes on the alcohol industry. Of that total, $7.6 billion comes from federal excise taxes, $3.6 billion from state and local excise taxes, $4.6 billion from state sales taxes, and $2.2 billion from local property taxes.[35] Taxes constitute an average of 43 percent of the purchase price of beer[36] and 61 percent of the retail price of a typical 750 ml bottle of spirits.

Total state alcohol tax collections remained unchanged from 1993 to 1995 at $3.6 billion, but fell slightly as a share of total state revenues, from 1 percent in 1993 to 0.9 percent in 1995. When state beer, spirits, and wine taxes are disaggregated, we find that average beer taxes fell 5 percent (from 24 cents a gallon to 23 cents); spirits taxes fell 3 percent (from $2.78 to $2.70); and wine taxes rose 8 percent (from 68 cents to 73 cents).

Three states increased their **taxes on beer** significantly between 1994 and 1996: Arkansas (25 percent), Wyoming (25 percent), and New Mexico (17 percent). Arkansas and Wyoming both started with beer taxes well below the national average and still have below-average tax rates. New Mexico, on the other hand, now has the nation's seventh highest beer tax. (See table.) Ten states cut their beer tax rates during the period, with Georgia (-33 percent), New York (-24 percent), and Washington (-20 percent) leading the way.

Some states, called "control states," allow alcohol to be sold only by state stores. The effective tax rate is reported as a tax above state store markup prices. Other states apply an excise tax per gallon. Four states increased their **spirits tax rates** between 1994 and 1996: Louisiana, New York, Georgia, and New Mexico. Eight states cut their tax rates: Wisconsin, Texas, Oklahoma, North Dakota, Nevada, Kansas, Illinois, and Hawaii.

Finally, nine states increased taxes on **table wine** while only one state (Ohio) cut taxes. The tax hikers were Wisconsin, South Carolina, Louisiana, Georgia, West Virginia, New Mexico, Washington, Hawaii, and Oklahoma.

For more information about changes to state beer, spirits, and table wine taxes from 1994 to 1996, see Tables 32 - 34 in the appendix.

States With Highest Alcohol Taxes, 1996

Beer	
($ per gallon)	
Hawaii	$0.91
South Carolina	0.77
North Carolina	0.53
Alabama	0.53
Florida	0.48
Mississippi	0.43
New Mexico	0.41
Oklahoma	0.40
Utah	0.36
Distilled Spirits	
(Control States, tax rate in addition to store markup)	
Alabama	56.0%
Washington	42.6
Montana	26.0
Vermont	25.0
Virginia	20.0
Maine	14.0
Michigan	13.85
Utah	13.0
(Non-Control States, $ per gallon)	
New York	$8.586
New Mexico	8.08
Oklahoma	7.42
Table Wine	
($ per gallon except Utah)	
Utah	13.0%
New Mexico	$2.27
Florida	2.25
Virginia	2.02
Georgia	2.02
Iowa	1.75
Montana	1.364
Hawaii	1.34
West Virginia	1.33
South Carolina	1.28

Source: Tax Foundation, October 1996.

D. Summary and Conclusion

There is evidence that since 1992, the shift in state spending toward entitlement programs and away from services that benefit all taxpayers may have stopped. The principal cause for this change was the ability of states to hold increases in Medicaid and education spending to below the rate of increase of total state spending, and to actually reduce spending on public aid.

The long-standing trends toward reliance on state individual income taxes and away from excise taxes also may have ended between 1994 and 1996. Individual income taxes fell slightly, as a share of total state revenue, between 1993 and 1995, and several states cut income tax rates in 1994 and 1995.

General sales taxes increased their share of total state revenues, but they increased at a much slower rate than did taxes on tobacco. Tobacco tax hikes in 1994 and 1995 suggest that tobacco taxes' share of state revenue will show an increase in 1996.

It is tempting to speculate that tobacco taxes are being hiked as a way to pay for income tax cuts, and in three states (Michigan, Arizona, and Connecticut) this may indeed have been the case. But the remaining six states that increased tobacco taxes did not cut income tax rates, nor did five states that cut income tax rates resort to higher tobacco taxes to pay for them. The most we can say is that hiking tobacco taxes may be a way for Republican governors to balance their budgets without raising other taxes: Eight of the nine governors who raised tobacco taxes between 1994 and 1996 were Republicans.

It seems reasonable to us that the changing direction of government spending is not entirely unrelated to the changing sources of government revenue. Prior to the 1990s, spending was steadily increased on entitlement programs *at the same time as* the tax system was becoming increasingly progressive. This growing divide between who receives public services and who pays for them helped set the stage for the 1994 election results. Many Republican candidates for public office elected in 1994 pledged to cut income taxes and reduce entitlement spending.

Candidates for public office elected in 1994 typically pledged to cut income taxes and reduce entitlement spending. Our review of the evidence suggests they have been successful in both of these areas, but have not succeeded in reducing the rate of growth of total state spending.

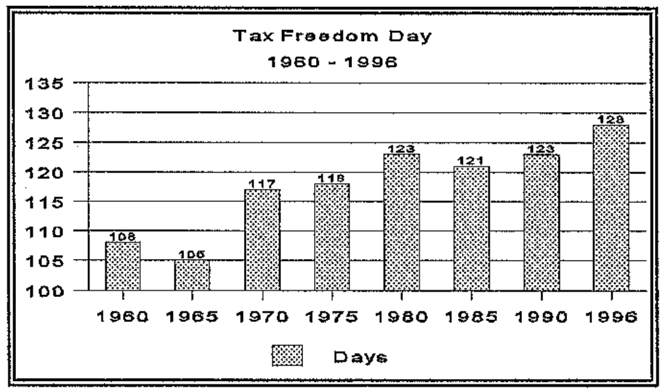
Our review of the evidence suggests they have been successful in both of these areas, while allowing other kinds of taxes and spending on other government programs to rise.

Part 6
Summary and Conclusion

To know where we are going, it is a good idea to know from where we have come. As Americans embark on a national debate over how best to change the nation's tax code, it is valuable to understand how the burden of taxation and beneficiaries of government spending have changed over time. We believe several conclusions with public policy relevance emerge from this analysis.

Tax burden is high by historical standards.

The most pronounced change in tax policy during the past forty years has been the rise in the level of overall taxes. The average real per-capita tax burden rose 121 percent between 1960 and 1992. The typical American family paid over 40 percent of its total income in taxes in 1995. In 1996, the average American had to work 128 days just to pay his or her taxes, compared to 108 days in 1960 and just 44 days in 1930.



Individual tax burdens grew dramatically, relative to personal income, until the 1980s, when sustained economic growth and lower rates of inflation allowed personal income growth to keep pace with the rising cost of government. Data from the 1990s suggest that government is once again growing faster than personal income.

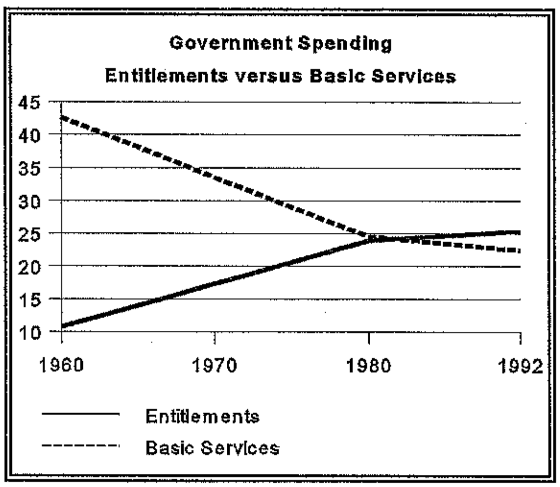
Reliance on income taxes is high by historical standards.

All three levels of government dramatically increased their reliance on income taxes as a source of revenue. At the federal level, the share of total revenue derived from individual income taxes remained relatively stable between 1960 and 1992, but Social Security and Medicare taxes rose from 7 percent of total revenues in 1960 to 17.4 percent in 1992. State governments increased the share of their total receipts from this source from just 8.3 percent in 1950 to 31.9 percent in 1993. Local governments, which historically have not relied on income taxes, nevertheless increased their real per-capita collections from this source by a remarkable 1,911 percent between 1950 and 1991.

Non-tax government revenues are also at historic highs.

Governments also burden their citizens with a variety of indirect costs that often escape public attention and debate. These non-tax government revenues include the cost of complying with the tax code ($235 billion a year), future obligations or debt (at least $180 billion a year), inflation ($142 billion in 1994), and complying with regulations ($677 billion a year). When added to the tax burden, these additional costs mean that Americans must work for the government a staggering 193 days a year before they can begin working for themselves. During the 1990s, inflation and the acquisition of new debt appear to have moderated, but the cost of complying with regulations is rising.

Spending has shifted toward entitlement programs and away from constitutionally required services and services that benefit everyone.



Spending on Social Security and Medicare, public welfare, and health rose from 10.7 percent of all spending in 1960 to 26.2 percent in 1992. While spending on these entitlement programs was rising, spending by all levels of government on defense, highways, and other constitutionally required or basic government services that benefit all citizens fell from 42.6 percent of all spending in 1960 to 21.9 percent in 1992.

Several long-term tax and spending trends slowed or stopped during the 1980s.

The trend toward spending on entitlement programs rather than constitutionally required services or services that benefit everyone slowed dramatically during the 1980s, as shown in the figure on this page. Nearly all of the trend noted for the long-term period (1960-1992) occurred prior to 1980.

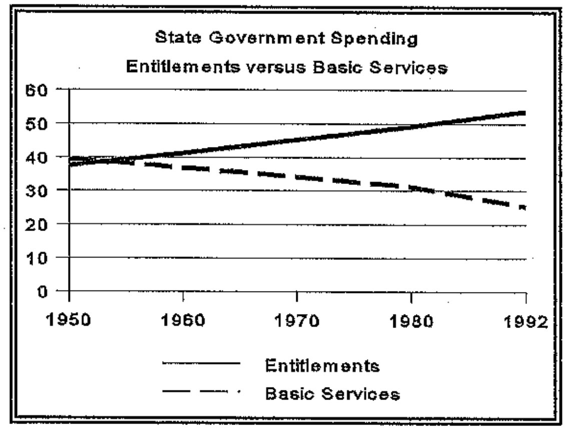
On the tax side, the federal government significantly reduced its reliance on individual income taxes during the 1980s. This reduction was largely offset, however, by state governments that continued their dramatic shift *toward* income taxes while lowering their reliance on property, corporate income, and excise taxes. After two decades of reducing their reliance on property taxes, local governments during the 1980s *increased* their reliance on this tax, and also increased their reliance on retail sales and excise taxes.

Interest on debt has emerged as a major expense item for all levels of government.

The federal government accounts for about 80 percent of all government debt, a share that has remained relatively constant since 1960. Debt has been rising for all levels of government, causing interest payments to emerge as the fourth largest expenditure item in 1992, accounting for 10.5 percent of all government spending.

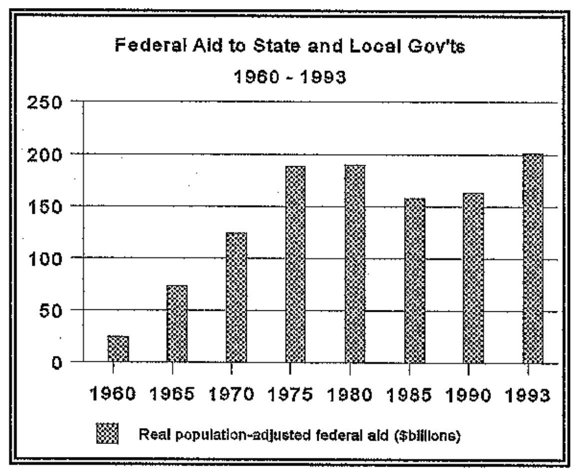
Spending by state governments during the 1980s continued to shift from basic services to entitlement programs.

Closer examination of government spending priorities reveals different trends at each level of government. At the state level, the trend toward spending on entitlement programs escalated during the 1980s, opposite the trend found at the federal level and for all levels combined. State spending on public welfare, education, and health and hospitals rose from 37.4 percent of total state spending in 1952 to 49.3 percent in 1980 and 53.8 percent in 1993. Meanwhile, state spending on basic services (natural resources, highways, and "other general spending") fell from 39.5 percent in 1952 to 31.3 percent in 1980 and 25.3 percent in 1993. Local governments experienced a weak trend toward entitlement spending from 1950 to 1980, and virtually no change in relative shares of spending during the 1980s.



Federal aid to state and local governments is at historic highs.

Contrary to popular belief, real per-capita federal aid to state and local governments did not fall during the 1990s, and now stands at a historic high. Such aid rose from $6.5 billion in 1960 to $88.7 billion in 1980 and $185.7 billion in 1993. Adjusted for inflation and population growth, real per-capita federal aid to state and local governments declined slightly during the early 1980s but rose rapidly during the late 1980s and early 1990s.



Several long-term trends reversed themselves during the 1990s.

The moderation of **total tax burden** during the 1980s, as measured by the Tax Foundation's Tax Freedom Day, was reversed during the 1990s. Americans had to work five more days in 1996 than in 1990 to pay for their taxes. The total number of work days required to pay for taxes rose from 123 in 1990 to 128 in 1996.

The long-term trend toward **income taxes** and away from other types of taxes stopped and probably reversed itself during the 1990s. State governments, which aggressively increased their reliance on income taxes prior to the 1990s, saw a slight decline in the share of total revenue raised through income taxes between 1993 and 1995. Eight states cut marginal income taxes in 1994 and 1995.

The trend at the state level toward **spending on entitlement programs** and away from basic services may have reversed itself in the mid-1990s. Between 1994 and 1995, state spending on Medicaid for the first time grew more slowly than did overall state spending, and spending on public aid fell from 5.1 percent to 4.0 percent of total state spending. Since the trend toward entitlement spending had already stopped or been reversed at the federal and local levels, it is likely that the trend toward entitlement spending by all levels of government combined also stopped during the 1990s.

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Tax policy and government spending priorities in the U.S. have changed in many ways, sometimes dramatically, during the past forty years. Due to the decentralized nature of the American system of federal government, it can hardly be said that these changes are the result of a deliberate plan or public consensus. Few people were in positions where they were likely to see or direct the "megatrends" identified here.

People who support more (or less) progressive taxation should be challenged to tell us whether they mean more (or less) progressive than in 1950, 1960, 1970, or 1996?

Understanding this history of taxes in the U.S. can help us make sense of proposals to change tax policy today and in the future.[37] People who support more (or less) progressive taxation should be challenged to tell us whether they mean more (or less) progressive than in 1950, 1960, 1970, or 1996. Depending on their answer, the policy change needed to achieve their objective may be the opposite of what they advocate.

Calls for more (or less) spending on entitlements or basic services should be met with a similar question: Was the balance between entitlements and basic services better in 1950 than in 1996? If it was, why did the balance change? And why, as is apparently the case, has the trend toward one type of spending and away from the other stopped in recent years? Shouldn't this be relevant to a discussion of future tax and spending policies?

The authors use the history presented here to reach their own conclusions on matters of fairness and efficiency in a companion volume to this report titled "How Fair? How Efficient?"[38] But we invite the reader to use this analysis to inform his or her own opinion on how tax and spending policies should be changed.

Endnotes

1. See "GOP leaders urge sweeping tax overhaul," Associated Press, *Chicago Tribune*, February 10, 1997, Section 1, page 7.

2. National Commission on Economic Growth and Tax Reform, *Unleashing America's Potential*, January 1996.

3. See Charles Tiebout, "A Pure Theory of Local Public Expenditures," *Journal of Political Economy*, 64 (1956), pages 416-424.

4. The following inflation multipliers were used to convert past dollars to 1996 dollars: For 1960, 5.2912; for 1980, 1.8995; for 1992, 1.1154. Population growth was 38.69 percent from 1960 to 1990 and 9.78 percent from 1980 to 1990.

5. Patrick Fleenor, "Tax Freedom Day 1996 is May 7," *Special Report*, Tax Foundation, April 1996. Most of the discussion in this section is based on the Tax Foundation's annual calculations of total tax burden.

6. The decline in real per-capita excise tax collections does not mean total taxes paid on specific commodities are going down. General sales taxes were increasingly being applied to goods, such as gasoline and alcohol, that were previously subject only to excise taxes. The subject is discussed later in this report.

7. Federal income taxes were indexed for inflation in 1981, ending "bracket creep" at the federal level but not at the state or local levels.

8. Unlike an income tax, inflation also reduces the purchasing power of cash holdings. For a typical discussion of the inflation tax, see Rudiger Dornbusch and Stanley Fischer, *Macroeconomics* (New York, NY: McGraw-Hill Book Company, 1978), pages 452-456.

9. Thomas D. Hopkins, "Regulatory Costs in Profile," *Policy Study* #132, Center for the Study of American Business, August 1996.

10. For comparisons of private and public compensation and retirement benefits, see Wendell Cox and Samuel Brunelli, "America's Protected Class III," *The State Factor*, American Legislative Exchange Council, April 1994; William J. Hunter, Wendell Cox, and Samuel Brunelli, "Wisconsin's Protected Class: How Public Employee Compensation is Bankrupting the State," *A Heartland Policy Study*, The Heartland Institute, March 26, 1993.

11. The June 1996 issue of *The Region*, a quarterly publication of the Federal Reserve Bank of Minneapolis, was devoted to the proceedings of a major conference on this subject. See "The Economic War Among the States," *The Region*, Vol. 10, No. 2 (June 1996).

12. Gross domestic product estimates for 1960 ($504.6 billion) and 1992 ($5.9 trillion) are taken from Table B-74 of the 1996 *Economic Report of the President*.

13. See Carol Jouzaitis, "No Consensus on Social Security Fix," *Chicago Tribune*, January 7, 1996.

14. *Statistical Abstract of the United States, 1995*, Table 478.

15. The following inflation multipliers were used to convert past dollars to 1996 dollars: For 1950, 6.5021; for 1980, 1.8995; for 1993, 1.0834. Population growth was 69.5 percent from 1950 to 1990 and 9.78 percent from 1980 to 1990.

16. See Charles Murray, *Losing Ground: American Social Policy, 1950 - 1980* (New York, NY: Basic Books, 1984); Marvin Olasky, *The Tragedy of American Compassion* (New York, NY: Basic Books, 1992, 1995); Michael Tanner, *The End of Welfare: Fighting Poverty in the Civil Society* (Washington, DC: Cato Institute, 1996).

17. See Eric A. Hanushek, *Making Schools Work: Improving Performance and Controlling Costs* (Washington, DC: The Brookings Institution, 1994); Sam Peltzman, "The Political Economy of the Decline of American Public Education," *Journal of Law and Economics*, April 1993, pages 331-370.

18. Michael Heise, "State Constitutions, School Finance Litigation, and the 'Third Wave': From Equity to Adequacy," *Temple Law Review*, Vol. 68, No. 3 (1995) pages 1151-1176.

19. See *Highway Statistics 1994,* Federal Highway Administration (Washington, DC: U.S. Government Printing Office, 1995), pages IV-5ff.

20. Data for the chart is taken from *Economic Report of the President 1996*, Table B-78. Dollar amounts were first converted to 1996 dollars and then adjusted to 1993 population. E.g., the 1993 federal aid figure in the chart, $201.2 billion, is actual spending of $185.7 billion multiplied by an inflation index of 1.0834 and divided by 1.0.

21. These statistics, and those that follow in this section, are from The Tobacco Institute, *The Tax Burden on Tobacco* (Volume 30, 1995), Table 16 on pages 164-196.

22. Some reviewers of an early version of this report objected to education being considered an entitlement, but others insisted that it is. Since it consumes over 40 percent of total local government spending, it seems necessary to include it in one category or the other. We chose entitlements because the connection between taxes paid and school services has become ever more tenuous over time as school districts get larger, public school choice programs expand, and as states increase their share of school funding. Since spending on education fell relative to spending on other services, its inclusion in the entitlements category makes the trend toward entitlement spending look slower than if it had been left out of the calculation, a result that should satisfy both sides in the debate.

23. The Bureau of the Census no longer is calculating state spending figures, and the Tax Foundation has not yet released its analysis of the raw data for fiscal year 1995.

24. For these calculations, the following estimates were used: 1992 population, 255,407,000; 1993 population, 258,120,000; 1995 population, 263,434,000; 1992 inflation index, 1.1154; 1993 inflation index, 1.0834; 1995 inflation index, 1.0269.

25. National Association of State Budget Officers, *1992 State Expenditure Report* (April 1993), *1995 State Expenditure Report* (April 1996).

26. *1995 State Expenditure Report*, National Association of State Budget Officers, April 1996, page 2.

27. Ibid., page 53.

28. See Malcolm S. Forbes, Jr., "She Does It Again," *Forbes*, February 13, 1995, page 25; Stephen Moore and Dean Stransel, "A Fiscal Report Card on America's Governors: 1996," *Policy Analysis* No. 257, Cato Institute, July 26, 1996.

29. Timothy J. Goodspeed and Peter D. Salens, "New Jersey Income Tax Cut Led to Savings, Not Rise in Local Taxes," *Civic Report*, Manhattan Institute, March 1996.

30. Allan Sloan, "Numbers Games," *Newsweek*, September 30, 1996, pages 48-49.

31. See note 11.

32. W. Kipp Viscusi, "Cigarette Taxation and the Social Consequences of Smoking," National Bureau of Economic Research, November 1, 1994, page 57.

33. John E. Petersen, "Go Forth and Sin Some More, Please," *Governing*, February 1997, page 70; Dr. John E. Berthoud, "A Tax Cut for Maryland?" *AdTI Issue Brief* No. 142, The Alexis de Tocqueville Institution, January 13, 1997.

34. Michelle Ruess, "Democrats balk at bill raising taxes to fund charity care," *The [Trenton] Record*, December 15, 1995.

35. "Are Higher Alcohol Taxes Justified?" Dale M. Heien, *Cato Journal*, Fall/Winter 1995/1996, page 253.

36. Adam D. Thierer, "Uncle Sam Socks it to Joe Sixpack," *Washington Times*, September 29, 1996. Thierer cites research by DRI/McGraw-Hill.

37. See Richard E. Neustadt and Ernest R. May, *Thinking in Time: The Uses of History for Decision Makers* (New York: The Free Press, 1988) for some useful tips.

38. Joseph L. Bast and Diane Carol Bast, *How Fair? How Efficient?* Heartland Policy Study No. 81 (Chicago: The Heartland Institute, May 1997).