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La Follette School of Public Affairs

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Working Paper Series

La Follette School Working Paper No. 2004-007

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The Impact of State Government Fiscal Crises on Local Governments and Schools

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This paper was published in *State and Local Government Review*, vol. 36, no. 2,
(Spring 2004): 86-102.



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by

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January 2004

The author would like to thank Vivek Bavda, Anna Niles, and Amanda Rogers for very able research assistance, and Donald Boyd, Donald Bruce, Howard Chernick, Ronnie Lowenstein, Kim Rueben, Eugene Steuerle, and Robert Tannenwald for comments on earlier drafts. He would also like to thank Arturo Pérez of the National Conference of State Legislatures for generously sharing data from an NCSL survey of state government education budgets.

Introduction

By historical standards, the recession that started in April 2001 was both short and mild. After a few months of decline, real gross domestic product was growing again by early 2002. The economic recovery, however, has been slow and uneven. The national unemployment rate, which was 3.9 percent in December 2000, has remained above 5.6 percent in every month between September 2001 and the present (January 2004). Despite the relatively mild recession, most state governments have been experiencing their worst fiscal crisis since at least the Second World War (National Governors Association, 2002). For three consecutive fiscal years, state governments in most states have had to close large budget deficits. And because many states relied on one-time funds to close these budget gaps, it is likely that they will again face substantial budget gaps for fiscal year 2005 (Boyd, 2003).

Steep declines in state tax revenues have forced states to repeatedly revise their revenue forecasts downward. Not only did aggregate state tax revenue decline in nominal dollars between June 2001 and June 2002, but when the data are adjusted for inflation and newly enacted tax increases are netted out, the decline in real revenue continues through June 2003 (Jenny, 2003). Figure 1 illustrates the starkly divergent paths of real GDP and state tax revenues since mid-year 2001. Even though most states took steps to restrain expenditure growth, rising costs, especially for Medicaid, increased the size of state budget deficits.

Although the magnitude of budgetary shortfalls varied across states, surveys of state fiscal conditions conducted by the National Conference of State Legislatures (NCSL) indicated that state governments, which in nearly all states must balance their budgets on an annual or biennial basis, faced gaps in their fiscal year (FY) 2004 budgets that totaled nearly \$80 billion. When combined with the fiscal problems that states faced in the prior two years, the NCSL estimated that since FY 2001 states have had to close cumulative budget gaps of nearly \$200 billion (National Conference of State Legislatures, 2003a).¹

¹In most states the governor must submit a balanced budget and/or the legislature must enact a balanced budget. If a revenue shortfall develops after the budget has been passed, however, in many states legislatures are not required to close the budget gap prior to the end of the fiscal year (Levinson, 1998).

In order to close budget gaps, states have a limited number of options. Over the past few years, most states have drained their rainy day funds, enacted cuts in state spending, raised additional revenue through taxes or fees, used various budget gimmicks and one-time funding mechanisms, or resorted to borrowing. Although there is a great deal of variation across the states, state governments appear to be relying much more heavily on spending cuts as opposed to tax increases as their primary means of balancing their budgets.

During the last round of state fiscal crises during and following the 1990-91 recession, a number of states relied quite heavily on tax increases to close their budget shortfalls. Across all states, legislated state government tax increases equaled 3.5 percent of state tax revenue in 1991, 4.8 percent in 1992, and 0.4 percent in 1993 (Gold, 1995b). During the current fiscal crisis, legislated tax increases are much smaller, equaling 0.2 percent of the previous year's state tax revenue in 2001, 1.5 percent in 2002, and 2.3 percent in 2003 (Johnson, Schiess, and Llobrera, 2003).

State governments play a dual role of directly providing a set of public services to state residents and transferring state-collected revenues to lower-level governments. Conventional wisdom suggests that state governments consider the funding of education to be one of their most important functions, and thus governors and legislators will try very hard, even in difficult fiscal environments, to maintain (or expand) funding for public schools and (perhaps to a lesser degree) for core municipal services, such as public safety. In this paper, I explore how state governments have in fact responded to recent budgetary shortfalls. Specifically, I try to determine the extent to which states have protected their local governments and school districts from funding cuts.

State and local governments are bound together in a complex set of relationships. First and most obvious, state governments provide substantial amounts of direct financial assistance to local governments and school districts. In some states, grants to local governments and school districts account for over half of state governments' general fund budgets. Therefore, it is not surprising that state grants

are at risk when state governments face large budgetary shortfalls. Second, each state must decide how to divide responsibilities for the provision of public services between its state and local governments. State governments are thus in the position to shift some of their current responsibilities to their local governments. By mandating that general-purpose local governments or schools provide additional services, but not providing adequate funding for these services, state governments are able to reduce their budgetary shortfalls without cutting public services. Third, and more subtly, cuts in state government programs, particularly those providing direct services for the poor, can raise the costs of public service provision for local governments. Large cities that have heavy concentrations of needy people are particularly at risk when state governments choose to cut services for the needy in response to budgetary crises.

In the next section of the paper, I briefly discuss the magnitude of the budgetary problems currently facing state governments. In the section that follows, I begin exploring the relationship between state government fiscal conditions and the potential impacts on local governments by looking in some detail at the role direct state aid plays in the financing of municipal governments and school districts. In the next two sections, I present data on state spending on K-12 public school education since FY 2002 and explore how the ability of school districts to deliver education to their students has been affected by state budgetary actions. In the following two sections, I explore how state budget cuts have impacted the state funding of municipal governments and how these governments are likely to respond to reductions in state funding. In the next two sections, I briefly discuss the possibilities that the current state government budget crisis will increase unfunded mandates imposed on local governments or result in an implicit shifting of costs from the state to local governments. The paper ends with a brief concluding section.

How Large Were State Government Budget Deficits?

Of the 47 states that responded to an NCSL survey conducted in early 2003, all but five states—Arkansas, Florida, New Mexico, North Dakota, and Wyoming—projected fiscal year 2004 budget gaps.

Although California projected the largest gap in dollar terms, at 36 percent, Alaska reported the largest gap as a percentage of its general fund budget. Eighteen other states projected budget gaps in excess of 10 percent of their general funds. (National Conference of State Legislatures, 2003b).

Although it is clear that many states were forced to close budget gaps that were larger than they had faced in decades, it is very hard to develop an objective measure of the relative size of the budget adjustments that states were forced to undertake. Because state governments do not report the size of their budget gaps in a consistent manner, interstate comparisons can be misleading. On the revenue side, the methodology used to make revenue estimates and the assumption behind these estimates differ markedly among the states. On the spending side, states pursue a variety of practices. Some states calculate a *current services* or a “*cost-to-continue*” budget. This budget can be defined as the amount of money needed in the next fiscal year to continue providing the same level of public services provided this year. The current services budget would be expected to grow from year to year to reflect any increases in populations served (e.g. students, the elderly), and changes in the costs of required inputs. For example, for FY 2004 rapid increases in health insurance premiums for state employees is one factor that causes a rise in states’ current service budgets. Although some states appears to have based the calculation of their budget gaps on the size of their current service budgets, other states are basing their deficit calculations on the nominal value of expenditures in the base year (generally FY 2003), and other states, on the current level of spending modified by some limited increases in spending that are explicitly mandated by state statute.

The State of Texas provides a good example of the differences in deficit estimates that emerge from different measures of spending. The Comptroller estimated a budgetary shortfall of \$9.9 billion for the 2004-2005 biennial budget period based on FY 2003 spending with adjustments for increases in health care and health insurance costs, but no adjustments for K-12 or higher education enrollment growth nor increases in debt service. The state’s Legislative Budget Board based its \$10.5 billion budget

shortfall estimate on a spending projection that assumed slower growth in health insurance, but allowed for higher spending for debt service and higher education enrollment increases. The Budget Board however ignored extra spending due to a large projected increase in the number of K-12 students. Finally, a Texas-based non-profit research organization projected a budgetary shortfall for Texas of \$15.6 billion on the basis of its estimate of the state's current services budget (Center for Public Policy Priorities, 2003).

State Fiscal Assistance to Local Governments

In the United States, the fiscal conditions of state and local governments are closely intertwined. According to Census of Government figures, nearly a third of the total expenditures of state governments are in the form of direct transfers to local governments. While the largest amount of this intergovernmental spending is for education, in many states, both county and municipal governments receive substantial amounts of state funds.

School districts and municipal governments are most at risk of facing cuts in direct state government fiscal assistance in states which allocate a relatively large share of their budgets to intergovernmental grants. The U.S. Census Bureau in its annual Census of Governments divides all state government spending into two categories—*direct expenditures* and *intergovernmental expenditures*. In fiscal year 2000, the latest year for which these data are available on a state by state basis, 30.2 percent of general expenditures by state governments were classified as *intergovernmental expenditures* (U.S. Census Bureau, 2002). Included in this spending category are all fiscal transfers to other governments, primarily counties, municipalities, and school districts. In five states, intergovernmental expenditures were in excess of 35 percent with California in first place with nearly 44 percent of all state expenditures in the form of grants or transfers to local governments.²

²In contrast, in Hawaii, where the state directly administers the public schools and the health and welfare system, only 2.4 percent of state expenditures go to intergovernmental transfers.

These Census data generally understate the vulnerability of local governments to cuts in state fiscal assistance. In most states, significant amounts of state spending comes from restricted or segregated funds. State legislatures, faced with big budget deficits, are often limited to making cuts in their state's general fund. In fiscal year 2000, the sum of state government general fund expenditures totaled \$498 billion, while total state government expenditures reported by the Census Bureau equaled \$1,084 billion.³ It is thus not surprising that intergovernmental spending is a much larger share of state general fund spending than of total state government spending. For example, Census data indicate that nearly 36 percent of total state government spending in Wisconsin was devoted to intergovernmental spending in fiscal year 2000. In the same year, however, the state reported that 57 percent of general fund appropriations were spent on local government assistance (Wisconsin Legislative Fiscal Bureau, 2000). In Illinois, approximately 44 percent of the general fund can be classified as intergovernmental spending, compared to only 29 percent of total state spending.

State Fiscal Crises and the Funding of Schools

During 2000-01, the last year for which these data are available, state governments provided approximately one-half of all the revenue of public elementary and secondary schools. Excluding Hawaii, which has a single state-wide school district, the share of revenue from state governments ranges from 28.6 percent in Nevada to 71.1 percent in New Mexico (National Center for Education Statistics, 2003a). Although politicians in most states have stated that they put a high priority on protecting the financing of K-12 education, the fact that in most states the largest portion of state government intergovernmental expenditures go towards the financing of public schools, puts K-12 education funding at risk. In this section of the paper, I explore the changes in state fiscal assistance to local school boards that have occurred in the two years since FY 2002. In both of the past two years, most state governments faced

³The data on General Fund expenditures come from the National Association of State Budget Officers (2001). Steven Gold (1995a) provides a very clear discussion of the strength and weaknesses of various sources of data on state government spending.

substantial current service budgetary shortfalls. Focusing on funding changes over this period will thus provide a picture of the direct impact of state fiscal crises on the funding of K-12 public education.

Each year, shortly after the beginning of the fiscal year, the National Conference of State Legislatures conducts a survey of the budget and tax changes enacted in the most recent budget cycle. Each state is asked to provide information on state government spending on K-12 education financed from state funds, but excluding spending for state administrative costs and excluding expenditures on capital construction. As many states faced large budget deficits in FY 2003 and FY2004, I will focus on changes in nominal state education spending between FY 2002 and FY2003 and between FY 2003 and FY 2004.⁴

Between FY 2002 and FY 2003 for the nation as a whole, K-12 spending by state governments increased by 2.7 percent. In the latest year, however, the rate of increase in spending was only 1.7 percent. These averages mask a great deal of variation across the states. The data in table 1 show that in 14 states, which collectively educate 46 percent of the country's public school students, state spending on K-12 education is lower this year (FY 2004) than last year. At the same time 9 states chose to increase education spending by 5 percent or more over the previous year's level. Over the two-year period from FY 2002 to FY 2004, 22 states, educating 57 percent of all public school students, cut their K-12 funding in at least one of the two years. Four states-California, Georgia, Massachusetts, and New Hampshire-reduced K-12 spending in both years, while 26 states had nominal increases in school aid in both years. The data in the right-hand columns of table 1 demonstrate that averaged over the past two years, state K-12 education spending was reduced in nominal terms in 11 states, and these states educate approximately 27 percent of all public school students. Thus, in a period of widespread reductions in many state government programs, the majority of states chose to spare K-12 public education from nominal cuts.

⁴The NCSL data for FY 2002 and FY 2003 were taken from Appendix M of Eckl and Pérez (2003). The FY 2004 on state K-12 education spending that is used in this paper comes primarily from an unpublished NCSL survey. Data for a few states has been adjusted to reflect budget information collected by the author directly from state government officials.

Nominal changes in state aid to education only provide a partial picture of the impact of state budget crises on public education. Although there is a great variation among states in the amount they spend on education, in all states the dollar cost of maintaining any given level or quality of education rises over time. Thus, even though state aid increased in some states over the past two years, these increases may not have been sufficient to maintain existing level of education services. Thus, to determine the real impact of state fiscal crises on education, it is necessary to calculate, for each state, a *current services* education budget. In other words, we want to know by how much spending must increase in order to maintain whatever level of public education each state was providing in a given base year.

In recent years there has been considerable interest in measuring the costs of education. Much of the work by economists has focused on estimating education cost functions within states.⁵ This work has tried to statistically identify a set of factors over which local school districts have no control, but which influence the amount of money districts must spend to achieve any given student performance objective. Among the factors that consistently influence costs are the size of a district, the concentration of poor children and children with limited English proficiency, and the area cost of living.

There has also been a limited amount of research focusing on the measurement of cost changes over time. Fowler and Monk (2001) discuss the shortcomings of using the consumer price index and review the limited work on developing alternative measures. Based on arguments first made by William Baumol (1967), they argue that the fact that most education spending goes to pay teachers, combined with the limited scope for increases in labor productivity over time, provides an important reason why the real (inflation-adjusted) costs of education tend to rise over time.

Ideally, one would like to estimate a current services education budget for each state that accounts for changes in a wide range of state-specific factors that have been shown to influence the cost of

⁵ See for example Duncombe and Yinger (2000) and Reschovsky and Imazeki (2003).

education. In light of limitations of both time and available data, in this paper I have employed a quite simple methodology for measuring the change over time in each state's current service education budget.

I start with the assumption that over time the costs of education are proportional to the number of enrolled students. As enrollment data for the 2003-04 school year are not yet available, I utilize state-specific enrollment projections produced by the U.S. Department of Education's National Center for Education Statistics (2003b). This procedure assumes that each gain or loss of students will change costs in proportion to existing average per pupil costs. While this is probably a good assumption in the long run, it is likely that the marginal cost of either gaining or losing a student will in the short-run, i.e. over a one or two-year period, be less than the average per pupil cost. To reflect this expectation, I constructed an alternative cost adjustment measure that assumed that costs would increase or decrease in proportion to 75 percent of any projected enrollment change. As this alternative measure of enrollment changes had little impact on the results, the data presented below is based on the assumption that costs vary in proportion to enrollment.

As a way of adjusting for annual increases in school district labor (including health insurance) costs, I have used the Bureau of Labor Statistics' (2003) Employment Cost Index for all state and local government workers. At the present time (October 2003) this index is available through the second quarter of 2003. To project the index for fiscal year 2004, I calculated the average ratio between the employment cost index and the urban consumer price index (CPI-U) for the past three years and then applied this average ratio to the 2004 CPI-U forecast produced by the forecasting firm Global Insight. With this estimated Employment Cost Index for FY 2004, I calculated an employment cost inflation rate of 7.83 percent between FY 2002 and FY 2004, and 3.17 percent between FY 2003 and FY 2004.⁶

⁶One argument against using the employment cost for state and local workers is that actual teacher salaries contribute to the calculation of the index, and thus the cost adjustment are not limited to factors which are completely out of the control of local school districts. However, as the focus of this paper is on the short-run adjustments of states to a severe fiscal crisis, and most school districts are in the short run bound by the terms of existing teacher labor contracts, the state and local worker cost index provides the measure of the cost increases

It is important to emphasize that by relying on a single cost inflation factor for the entire country, I ignore potentially important differences among the states in changes in the cost of a current service education budget. For example, the costs of education are likely to rise at a faster than average rate in a state faced with educating an increasing number of non-English speaking children from immigrant families. Likewise, housing market booms in some areas of the country will require school districts in these areas to pay higher than average salaries to attract new teachers.

Using the just described enrollment and employment cost adjustments, I calculate for each state the percentage change in, what one might call, real per pupil state government funding for K-12 education between FY 2002 and FY 2004 and between FY 2003 and FY 2004. The results of these calculations indicate that for the nation as a whole real state aid declined by 1.6 percent from FY 2003 to FY 2004 and by 3.6 percent from FY 2002 and FY 2004. As an example of these calculations, consider North Carolina, where state aid to education increased in nominal dollars by 0.3 percent between FY 2002 and FY 2003 and between 2.7 percent from FY 2003 and FY 2004. Over this period however, enrollment grew by 0.6 percent and, applying the national rate, the costs of education by 7.8 percent. As a result, after two years, the North Carolina's real support for public education was reduced by 5 percent.⁷

The data in table 2 demonstrate that while the real support for education actually increased in some states, in the majority of states, the past two fiscal years were a period of declining real support for

faced by the average district. Nevertheless, as an alternative measure, I calculated the increase in costs using the employment cost index for Private Sector, Professional and Technical Workers. Using this index, employment cost inflation would be 7.1 percent between FY 2002 and FY 2004 and 2.87 percent between FY 2003 and FY 2004. As indicated in more detail in footnote 8, the use of this alternative index results in only minor differences in the percentage changes in real state aid displayed in table 2.

⁷ The percentage change in real per pupil state education spending is calculated by applying the following formula: $\{(1 + \delta)/[(1 + \alpha)(1 + \beta)]\} - 1$, where δ = the percentage change in state support, α = the percentage change in student enrollment, and β = the percentage change in employee costs.

K-12 education. In 35 of the 49 states for which I have data, real per student funding is lower this year than it was two years ago.⁸ These 35 states educate 75 percent of all K-12 public school students.

Figure 2 illustrates the spatial pattern of the changes in real per student state funding for K-12 education between FY 2002 and FY 2004. It is interesting to note that the 17 states in which real state spending declined by more than five percent are found in all parts of the country. Not surprisingly, many of the states that increased state support for education are states that rely on severance taxes, a sources of revenue that tends to be more stable than income or sales taxes.

School District Responses to Reduced State Assistance

The fact that in many states there are now fewer state government resources to support public education than there were prior to the current economic downturn does not necessarily mean that the overall support for public education has been reduced. Except in states that limit annual property tax increases, school districts are in principle free to compensate for reductions in real state resources by increasing their own contributions to the funding of education. Whether school districts in states that have reduced real per pupil support for education will be able to maintain the existing quality of education will depend in large part on their ability and willingness to increase local resources.

In general, school districts are fortunate that their locally-raised revenues are less sensitive to economic downturns than the revenues of state governments. While state governments rely heavily on the individual and corporate income tax and the sales tax, school districts rely primarily on the property tax—a tax whose revenue is much less likely to decline during recessions. While state tax revenue after adjusting for inflation and legislated changes has declined for eight straight quarters since the second quarter of 2001 (Jenny, 2003), property tax revenue has continued to grow throughout the period. Census data show that for the nation as a whole, four-quarter total property tax collections for the quarter ending

⁸If the real changes in state aid are calculated using the private sector professional and technical workers cost index, two fewer states, with 3.6 percent of all students, would have reduced real per pupil state aid between FY 2003 and FY 2004, and one fewer state, with 0.6 percent of all students, would have decreased per pupil state aid between FY 2002 and FY 2004.

in June 2003 were 1.3 percent higher than the four-quarter total ending in June 2002 and 11.6 percent higher than the four-quarter total ending in June 2001 (U.S. Census Bureau, 2003b).⁹

These increases in property tax collections are due in part to rapid increases in property values in many parts of the country.¹⁰ It is likely that the ability of school districts to raise additional property tax revenues without raising property tax rates will make it easier for them to compensate for the loss of state aid.

It is easy to show that for any given percentage reduction in real state government support for education, the percentage increase in non-state government resources needed to maintain a constant level of real per pupil support for education is equal to the ratio of the state government share to the non-state government share of total education resources.¹¹ I have calculated that in the 10 states with the largest percentage reductions in real per pupil state support for education between FY 2002 and FY 2004, non-state resources would have to increase by from 4.5 to 21 percent in order to maintain a constant level of real support for education. Among these 10 states, the average required increase in non-state support would be 13.6 percent.

Although the residents of some school districts would undoubtedly support increases in property tax levies of this magnitude if they were convinced that these tax increases are necessary in order to maintain the quality of the education provided by their public schools, in many other school districts, there would be strong political opposition to double-digit increases in school property tax levies. Also, in

⁹These property tax data are for all local governments, including school districts, municipalities, and county governments.

¹⁰In 2001, inflation-adjusted home prices increased by 5.7 percent, a rate that was faster than in any year since 1978. In 2002, the rate of increase of home prices was nearly as fast as in the previous year (Joint Center for Housing Studies of Harvard University, 2003).

¹¹ This result is derived by setting the percentage change in real per pupil education resources (E^*) equal to zero in the following identity, and solving for the percentage change in non-state revenue:
 $E^* = \gamma(\% \text{ change in real state funds}) + (1 - \gamma)(\% \text{ change in real non-state funds})$, where γ is the share of total K-12 education revenue from the state.

a number of states, legislatively- or constitutionally-enacted property tax limits, restrict the amount of additional property tax revenue that can be collected each year.¹² For example, in California, Proposition 13 limits annual increases in the assessed value of property to two percent unless properties are sold. And Proposition 2½ in Massachusetts limits annual increases in property tax levies to 2½ percent per year.

There is a considerable amount of anecdotal evidence that school districts around the country have responded to tight budgets by appealing to parents and to communities for increased voluntary contributions. It also appears that school districts are increasing their reliance on student fees to help finance specialized programs such as athletics. Two recent papers by Brunner and Sonstelie (2003) and Brunner and Imazeki (2003) have documented the widespread use of voluntary contributions by public schools in California. Although the use of voluntary contributions is very common, the evidence in California is that only in a few school districts would per pupil contributions be large enough to replace substantial losses in state education aid.

Although no comprehensive review of the fiscal condition of school districts exists, it appears that in many states the reduction in nominal and real state education grants is coming at a very bad time. Around the country school districts are facing increased pressure to improve their students' performance. Many states have recently enacted legislation tightening graduation requirements and mandating new "high stakes" student performance tests. In addition, the new federal education bill, the *No Child Left Behind Act of 2001* (NCLB) mandates annual testing of all students in grades 3 through 8 and requires that schools make annual progress in meeting student performance goals for all students and for separate groups of students characterized by race, ethnicity, poverty, disability, and limited English proficiency. The federal legislation rewards schools that succeed in meeting state-imposed achievement goals and sanctions schools that fail.

¹²For a detailed description of the various property tax limitations enacted by various states see Advisory Commission on Intergovernmental Relations (1995).

There is a growing body of empirical evidence that suggests that for many school districts the minimum amount of money needed to meet these new performance standards exceeds the current level of spending. This is particularly true in school districts with heavy concentrations of children from economically disadvantaged families (Reschovsky and Imazeki, 2003; Dumcombe and Yinger, 2000). The implication of this research is that without an infusion of new resources a growing number of school districts will be labeled as “failing”.

The data reported in the previous section of this paper suggest that rather than increasing fiscal assistance to its school districts, many states have reduced education funding, at least in real terms. These aid reductions will place many school districts, especially those with high concentrations of poor and special education students, in a very difficult position. To the extent that additional spending is needed in order to improve education quality, these districts will face the politically difficult task of raising property taxes. As previously indicated, in some states, property tax increases are prevented or limited by state-imposed prohibitions. Even in states without tax and expenditure limitations, opposition to tax increases appears to be very strong.¹³ The combination of cuts in state funding for education, the inability to adequately raise property taxes, and the rising costs of meeting new student performance standards suggests that over the next few years we will see a significant rise in both the number of schools classified as “failing” and number of students receiving an inadequate education.

State Fiscal Crises and the Funding of Municipal Governments

All state governments allocate some portion of state revenues to their local municipal governments. In fiscal year 2001, state governments provided about \$64.6 billion to their municipal (including township) governments, an amount that accounted for 21 percent of the general revenue of these governments (U.S. Census Bureau, 2003a). These national numbers somewhat overstate the role that most states play in the funding of local general-purpose governments. In a few states, most notably

¹³ In both Alabama and Oregon, voters chose to reject tax increases even though it was widely recognized in both states that without additional tax revenues, spending on schools would be reduced.

New York, municipal governments are responsible for both public education and for welfare. As a consequence the national data on state aid to municipalities includes a portion of these states' support for education and welfare.

In the majority of states, state government financial support for local governments takes the form of grants for specific purposes, most commonly, for highway construction and maintenance. Relatively few states provide their municipal governments with unconditional grants in support of municipal functions. Based on a survey I conducted of budget officials in each state, I have identified 16 states that are providing their municipal governments with unconditional aid in FY 2005. These states, and the amount of aid, both in total dollar and in per capita terms, are listed in table 3. Per capita aid amounts are under \$50 in 7 states and over \$150 in five.

Conditional grants to local governments, especially those for highway maintenance, are often funded from earmarked motor vehicle or gasoline taxes. Although conditional grants may indeed be fungible, it is nevertheless most likely that in periods of state budgetary shortfalls, unconditional grants to local governments will be prime candidates for budget reductions. The results of my survey of state budget officials suggests that most of the states that provide their local governments with unconditional aid reduced that aid, in some cases substantially, as part of the process of balancing their FY 2004 budgets.

The data in table 3 show that with the exception of Florida, Rhode Island, and Vermont, which increased municipal aid, most of the other states chose to reduce unconditional grants to their local governments. While Kansas completely eliminated its local government unconditional grant program, California, Massachusetts, Minnesota, and Nebraska reduced unconditional grants by over 10 percent. Determining the impact of these reductions in grants on the ability of local governments to provide municipal services is beyond the scope of this paper. However, the fact that municipal government grants have been substantially reduced in some states, suggests that at least in those states, local government

residents in their role as property taxpayers and as recipients of local government services are bearing a portion of the burden of the state fiscal crisis.

How Will Local Governments Respond to Less State Aid?

In this section of the paper, I explore the question of how local governments are likely to respond to a reduction in state funding. As most local governments operate under quite strict balanced budget requirements, they essentially have only two options—enact increases in locally-raised revenue or reduce spending. Unless efficiencies in service delivery can be implemented or public employee salaries can be reduced, cuts in spending will translate directly into reductions in public services.

Although many municipal governments get nearly all their tax revenue from the property tax, it is important to emphasize that in some states, local governments also rely on income and sales taxes.¹⁴ For these governments, cyclical reductions in local tax revenue will exacerbate the fiscal problems caused by cuts in state aid. New York City, for example, had to close an enormous budget deficit in part because it relies quite heavily on revenue from both a city income and a city sales tax.

Drawing general conclusions about how local governments will respond to cuts in state aid is particularly hard to do. Although, the economics literature contains a few studies about the response of state and local governments to cuts in federal aid, the evidence, which is described in Gamkhar (2002), is mixed. Some studies suggest that state and local governments act symmetrically to increases and decreases in grants. This implies that cuts in aid will result in declines in spending. Other studies, however, suggest that state and local governments respond to cuts in grants by raising taxes sufficiently to make up for most of the lost grant funding. It is also not clear to what extent empirical results about responses to cuts in federal grants will hold for cuts in state grants.

In some local jurisdictions, constitutionally- or legislatively-imposed property tax limitations will limit the extent to which local governments can increase local revenues to make up for losses in state aid.

¹⁴In fiscal year 2001, property tax revenue accounted for 52.9 percent of all tax revenue raised by municipal governments (including townships).

In those cases, cuts in spending will be the only alternative. It is at least possible that some state legislatures will take actions to enforce cuts in local spending. For example, in Wisconsin, the legislature passed a three-year freeze of municipal government property tax levies, a provision that would have prevented property tax increases to compensate for reductions in state aid. The property tax freeze was, however, vetoed by the governor.

The impact of state cuts in fiscal assistance on the ability of local governments to deliver public services depends to a significant degree on exactly how states choose to implement their aid reductions. States generally distribute fiscal assistance to local governments in an equalizing manner. This implies that grants per capita or per student are larger in local jurisdictions in weaker fiscal condition, which in most states means jurisdictions with smaller per capita or per student property tax bases. As a result, financial assistance from the state finances a large portion of local spending in some jurisdictions compared with others.

If a state government chooses to reduce aid by an equal percentage amount in each local jurisdiction, the result will be very large reductions of aid relative to local spending in the municipalities or school districts in the weakest fiscal conditions. Equal per capita or per student reductions, although they may result in the complete elimination of state aid to some high-income communities, will have a much less deleterious impact on the ability of local governments to continue to provide public services. If a state wanted to maintain its current level of equalization, reductions in state aid should be targeted to the local governments and school districts in the strongest fiscal condition.

Although there is little systematic information about the pattern of previous aid cutbacks, it seems reasonable to assume that a different set of political forces may operate in periods of economic growth and periods of decline. In a period when state spending is growing, legislatures often agree to increase state aid using "equalizing" formulas. Although every local government may receive additional state assistance, the new money would be distributed using formulas that allocate larger per capita grants to

local governments with smaller per capita tax bases. Because local governments may come to consider any grant amount received in one year to be their “entitlement” in the next year, in periods of reductions of state funding, most local officials will argue for the smallest possible reduction in their state aid allocation. One solution that some argue is “fair” would be to reduce each jurisdiction’s state aid allocation by the same percentage amount. For any existing state aid allocation that provides larger per capita grants to poorer municipalities, equal percentage reductions in aid result in per capita cuts in aid that are largest, both in absolute terms and relative to municipal wealth, in the poorest communities. The result of equal percentage reductions in aid is thus a grant system that is less equalizing after the aid cuts than before. A strategy that called for equal per capita aid reductions or perhaps larger reductions in state aid for municipal governments in the strongest fiscal condition and smaller reductions in aid for those municipalities in weak fiscal health would retain, or even expand the equalizing effect of a state aid system.

Although, to my knowledge, no one has systematically studied the distributional pattern of reductions in state aid, Reschovsky and Schwartz (1992) posited a model where each state legislator would vote for whatever aid cutback plan produced the smallest possible aid reduction for the communities in the legislator’s district. Under this model of legislative decision-making, a plan that targets large aid cutbacks to a relatively small number of communities will prove to be victorious. The authors applied their model by simulating the voting of Massachusetts legislators on several alternative aid cutback plans. The results of their exercise suggested that a plan that involved cutting aid to all local governments by an equal percentage amount would receive the most votes, and that there would be no support for a plan calling for an equal per capita cut in aid. At least in Massachusetts, this exercise leads to a prediction that cutbacks in state aid to municipal governments will reduce the degree of fiscal equalization produced by the state’s system of municipal grants-in-aid.

Additional Impacts of State Budgetary Problems on Local Governments

Cutting state grants to local governments is the most direct way for state governments to impose part of the solution to their fiscal problems on local governments. In this section, I briefly outline two additional ways in which state fiscal problems can be shifted to local governments.

Unfunded Mandates An effective way for state governments to close their budget gaps is to shift the responsibility for providing some public services to lower-level governments without providing those governments with adequate additional funding to carry out their new responsibilities. Municipal and county governments throughout the country have complained for years about the growth of these unfunded mandates. In some states, for example New York, the governor's fiscal year 2004 budget proposal contained explicit mandate relief. In other states, however, budget proposals called for expanding the use of unfunded mandates. For example, in Wisconsin, the FY 2004 budget shifted one-half the cost of assessing manufacturing property from the state to local municipalities, and a legislative task force proposed the elimination of the state police with its functions to be filled by county sheriffs.

Implicit Cost Shifting In balancing their budgets many states cut spending on a wide range of state programs for the poor and needy. According to research conducted by the Center on Budget and Policy Priorities, budgets enacted by a large number of states tightened eligibility for public health insurance, increased co-payments for many Medicaid services, and cut eligibility for child care subsidies (McNichol and Schiess, 2003).

Although, municipal governments have no formal role in the funding of these programs, funding reductions at the federal and state level may have direct fiscal implications for local governments, especially in cities with heavy concentrations of poor families. Reductions in state funded human services, not only create hardships for individuals, but may exacerbate the fiscal problems of the communities in which they live. In other words, cuts in state spending may well result in an *implicit* shifting of costs from the state to local governments.

As either direct services provided to the needy or the state funding of those services are reduced, city governments must often pick up the responsibility for providing or financing those services. Even in cases when municipal governments are not legally responsible for providing and financing services, as the “first responders” to accidents, illness, homelessness, and other manifestations of need, municipal governments often end up bearing much of the direct cost of providing services to the needy. As county governments in many states have primary responsibility for providing most poverty-related services, this form of cost shifting is most likely to occur in cities that are coterminous with county boundaries.

In a recent paper, Robert Inman (2003) calculates the tax cost that City of Philadelphia residents must bear to finance direct poverty-related spending. His analysis demonstrates that poverty spending is much higher in Philadelphia than in its suburbs, and that city residents must bear tax burdens to finance poverty-related spending that are four to seven times higher than those borne by residents of the four surrounding Pennsylvania counties. If the state of Pennsylvania reduces its spending on programs for the needy, costs are likely to be shifted directly to the county/city government. For example, if a reduction in state Medicaid funding leads to an increase in the number of uninsured families, it is likely that some of the health care costs of the newly uninsured will have to borne, directly or indirectly, by the city government. Also, reductions in state-funded housing programs, or cuts in welfare benefits may directly increase the demand for places in city-financed homeless shelters.¹⁵

Reduced funding for state-financed social programs can also have indirect fiscal impacts on local governments. For example, econometric evidence exists that concentrated poverty is associated with higher costs of achieving any given level of public safety (Bradbury et al, 1984; Ladd and Yinger, 1991; Green and Reschovsky, 1994). Not only is the incidence of crime higher in areas of concentrated poverty, but community attributes associated with poverty, such as high density and poor housing conditions,

¹⁵The extent of cost shifting will vary by city, with the impacts in any given municipality depending on the concentrations of needy populations, the coincidence of city and county boundaries, and the role played by the non-profit sector in funding services for the needy.

increase the amount of resources required to provide public safety in these neighborhoods. Increased poverty caused by high unemployment and exacerbated by cuts in cash and in-kind assistance are likely to increase the amount of money city governments will need to maintain existing levels of public safety.

Conclusions

Nearly all states have faced substantial and repeated budgetary shortfalls over the past three years. Recent evidence from a number of states suggests that the end is not in sight. Sluggish revenue growth and expected increases in the costs of state programs, especially Medicaid, will result in large budgetary shortfalls in many states in FY 2005 (Johnson, 2003). In this paper, I trace the complex inter-relationship between state and local government finance, and using recent data on changes in state spending patterns, demonstrate that an important part of the strategy followed by many states in balancing their budgets was to reduce state funding of K-12 public education and, in states where it exists, unconditional fiscal support for municipal governments. I also demonstrate that, when one takes account of the rising costs of education and the changes in enrollment, school districts in 34 states, collectively educating three-quarters of all public school students in the U.S., are receiving fewer state resources per student than they were two years ago. It thus is reasonable to conclude that the fiscal problems facing state governments over the past few years are being shifted down to school districts and in some states to municipal governments.

The important and for now unanswered question is whether the state government fiscal crises of the early 21st century will lead to a significant deterioration in the quantity and quality of public education and municipal public services in the United States. To some extent the answer to this question will depend on whether municipal governments and school districts are willing and able to compensate for a reduction in state funds by increasing local fiscal resources devoted to education and municipal public services. In communities where the sum of state and local fiscal resources are reduced, we would

clearly like to know whether local school districts and municipal governments will find ways to maintain existing levels of public services?

The answer to this question is clearly beyond the scope of this paper. It is reasonable to ask, however, whether there exists any evidence from past state government fiscal crises concerning the ability of local governments and school districts to maintain public services during periods when fiscal resources are reduced. Although the evidence is limited, two studies of education funding directly address this question.¹⁶ Robert Berne and Leanna Stiefel (1993) explore whether the New York City's fiscal crisis of the mid-1970s had a long run impact on the delivery of education services in New York. Their approach is to use annual data from 1970 through 1990 and to compare New York City schools with schools in the rest of New York State. New York City schools suffered large budget cutbacks in both 1976 and 1977. The most obvious impact on education services was a 90-minute reduction in the length of the school day for all but high school students. Although the shortened school days were eliminated in 1978, Berne and Stiefel found much longer-lasting impacts along a number of dimensions, including lower per pupil real spending, larger class sizes, and an increase in deferred maintenance.

In a more recent paper, Boyd, Lankford, and Wyckoff (2002) study school budgeting behavior of New York State schools over the period from 1980 through 2000, a period that included the state fiscal crisis of the early 1990s. They found that in periods of fiscal stress, school districts generally have limited ability to cut many types of non-instructional spending. For various statutory or contractual reasons, spending on teaching students with disabilities, debt payments, and health care expenditures all continued to grow during periods of fiscal stress. They found that those school districts that had managed to build up unrestricted cash balances were generally able to maintain instructional budgets during periods of

¹⁶ In a third study, Helen Ladd (1997) uses cross-section data on school districts in Texas to explore how school district budgetary decisions and staffing patterns differ in school districts in weak and in strong fiscal condition. She found that districts in weak fiscal condition tended to spend a larger share (although smaller absolute amount) of their budgets on instruction as opposed to administration or school maintenance. She emphasized, however, that the methodology she used provides no information on short-run budgetary responses to fiscal stress.

fiscal stress by drawing down balances on these accounts. Districts without large balances were forced, however, to reduce their instructional budgets.

Although these studies are suggestive, further research is clearly needed if we are to predict with confidence the impact of state fiscal crises on the ability of school districts and municipal governments to deliver existing levels of public services.

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Percentage Change in State Funding for K-12 Public Education

	Fiscal Year 2003 to 2004				Fiscal Year 2002 to 2004			
	Percentage Change in Nominal School Aid		Percentage Change in Real per Pupil State Aid		Percentage Change in Nominal School Aid		Percentage Change in Real per Pupil State Aid	
Alabama	-0.3%	14	-3.5%	14	1.9%	15	-4.4%	19
Alaska	-2.7%	6	-6.9%	5	0.3%	10	-8.4%	6
Arizona	10.6%	47	5.1%	46	11.8%	43	2.0%	42
Arkansas	2.1%	26	-0.9%	29	3.8%	25	-2.3%	31
California	-0.5%	13	-5.0%	10	-2.0%	3	-10.7%	4
Colorado	4.2%	41	-0.3%	33	16.2%	47	7.2%	48
Connecticut	1.5%	23	-2.1%	22	0.2%	8	-6.8%	9
Delaware	2.6%	31	-1.9%	23	5.5%	33	-2.9%	27
Florida	6.3%	43	1.6%	42	12.0%	44	3.0%	44
Georgia	-1.8%	10	-6.0%	7	0.6%	12	-7.6%	7
Hawaii	9.7%	45	5.2%	47	10.5%	42	1.0%	39
Idaho	1.3%	22	-3.1%	16	3.6%	24	-4.8%	15
Illinois	5.9%	42	2.0%	43	5.0%	31	-2.6%	28
Indiana	13.0%	49	8.9%	49	27.8%	49	18.9%	49
Iowa	2.3%	28	-0.7%	30	3.2%	22	-3.7%	23
Kansas	-9.2%	1	-11.9%	1	-7.7%	1	-12.7%	2
Kentucky	3.4%	35	0.5%	39	6.4%	36	1.8%	41
Louisiana	-5.0%	3	-7.5%	3	2.0%	16	-4.2%	20
Maine	1.0%	20	-1.6%	25	3.4%	23	-2.4%	29
Maryland	7.0%	44	2.9%	44	12.6%	45	4.0%	45
Massachusetts	-5.7%	2	-9.1%	2	-7.2%	2	-13.7%	1
Michigan	-0.9%	12	-4.9%	11	-1.8%	4	-11.7%	3
Minnesota	3.7%	37	0.7%	40	30.4%	50	23.1%	50
Mississippi	0.7%	19	-2.4%	20	7.1%	38	0.3%	38
Missouri	-3.8%	4	-7.0%	4	0.2%	9	-6.4%	11
Montana	-3.6%	5	-5.8%	8	-1.2%	6	-6.8%	8
Nebraska	-2.4%	7	-5.3%	9	-0.8%	7	-6.6%	10
Nevada	11.4%	48	3.7%	45	18.4%	48	4.4%	47
New Hampshire	-1.8%	9	-4.8%	12	0.3%	11	-6.2%	13
New Jersey	10.0%	46	5.3%	48	13.8%	46	4.2%	46
New Mexico	4.0%	40	0.3%	38	5.1%	32	-3.2%	26
New York	-1.2%	11	-4.5%	13	1.7%	14	-5.6%	14
North Carolina	2.7%	32	-1.2%	26	3.8%	26	-3.8%	22
North Dakota	1.6%	24	-0.1%	36	5.8%	35	1.5%	40
Ohio	1.9%	25	-1.2%	27	5.6%	34	-1.0%	34
Oklahoma	3.8%	38	0.9%	41	2.1%	17	-2.3%	30
Oregon	21.1%	50	16.8%	50	2.7%	21	-4.4%	17
Pennsylvania	4.0%	39	0.3%	37	8.0%	40	-0.5%	37
Rhode Island	3.3%	34	-1.0%	28	7.7%	39	-2.1%	32
South Carolina	0.3%	16	-3.4%	15	0.8%	13	-6.3%	12
South Dakota	2.5%	30	-0.4%	32	2.3%	18	-3.5%	24
Tennessee	2.1%	27	-1.7%	24	7.0%	37	-1.0%	35
Texas	-2.3%	8	-6.4%	6	3.8%	27	-3.9%	21
Utah	1.3%	21	-2.7%	18	-1.4%	5	-8.4%	5
Vermont	2.4%	29	-0.3%	34	2.5%	19	-3.4%	25
Virginia	3.6%	36	-0.7%	31	4.8%	29	-4.4%	18
Washington	0.6%	18	-3.0%	17	2.6%	20	-4.6%	16
West Virginia	2.8%	33	-0.2%	35	4.9%	30	-0.9%	36
Wisconsin	0.5%	17	-2.4%	21	4.6%	28	-1.4%	33
Wyoming	0.0%	15	-2.5%	19	8.1%	41	2.0%	43
Average	1.8%		-2.1%		4.4%		-3.6%	