1. Introduction

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In the history of the United States there have been numerous forces that have had profound effects on the structure of state and local government finances. For example, the Great Depression led many states to implement a sales tax; during the 1930s, 24 states adopted the sales tax. The adoption of the Great Society programs in the 1960s resulted in new and expanded state and local government expenditure programs and a substantial increase in reliance on federal grants. Comparisons of the structure of state and local government finances before and after bear witness to the impacts of these events.

Today, state and local governments face numerous pressures, not just one major force. The chapters in this volume explore the nature of these pressures, discuss their implications for the finances of state and local governments, and explore how these forces play out in terms of changes that state and local governments will and should undertake in response to these pressures. These forces stem from technological advances, court rulings, federal government policies, changes in population demographics and in the nature of the economy, and political pressures.

Each of these forces by itself is not likely to have the impact that a Great Depression or Great Society had, but taken together they confront state and local governments with the need to make substantial changes in their fiscal systems. These pressures represent a diverse set of forces. Thus, rather than having to react to one event or force by, for example, adopting a new tax source, state and local governments are being pressured to adjust along multiple dimensions.

Unlike the Great Depression, the pressures that state and local governments face today do not require immediate adjustments to their fiscal systems. Failure to act in the short term will not be devastating to state and local governments. But longer term, the failure to act is likely to result in substantial adverse effects and increasing pressures that will require more substantial changes, changes that are more difficult to implement and changes that are more politically unpalatable. Without change, state and local fiscal systems will grow increasingly out of sync with economic reality. It will be death by a thousand pin pricks, not by a gun shot.

Because the effects in the short run of not acting in response to these pressures will be small, state and local governments will be inclined to avoid making the necessary changes. Over time, some state and local governments will likely realize that their fiscal systems do not match the environment and will begin to make changes. But other governments will wait it out until a fiscal crisis occurs. Thus, governments will change at different times and at different rates, and the responses are therefore likely to be evolutionary, not revolutionary. The response to some of these pressures will be noticeable in the short run, but for other pressures, we will see only small changes within five or ten years. However, in, say, 25 years we will witness the fact that substantial changes have occurred in how state and local governments conduct their fiscal affairs.

Compared to the previous 20 years, the past 20 to 25 years can be categorized as ones of stability in state and local finance. Ronald Fisher in Chapter Two sets the stage with an overview of how state and local government fiscal affairs have changed over the past 20 years in contrast to the changes during the previous 20 to 40 years. The size of the state and local sector relative to the size of the economy has remained essentially constant. In terms of the composition of expenditures and revenue sources and the importance of states relative to local governments, there has been little change. Expenditures on health and criminal justice have increased while transportation spending has decreased as a share of total expenditures. Charges for services have increased relative to other revenue sources and state governments have become somewhat more important relative to local government. But in contrast to the 1960s and 1970s, these changes are modest.

In Chapter Three, Sally Wallace discusses the changes in the demographic and economic profiles of the US, how they are likely to change in the future and the potential effect these changes will have on state and local government finances. There are many changes occurring to the demographic profile of the US population, to the nature of the output of the economy, and to the sources of household income. The aging of the population is one trend that has received considerable attention, particularly as to how it affects the future of social security. But the changes in the age distribution also have implications for state and local government finance, both on the revenue and expenditure sides of the budget. In addition to the aging of the population, the US is experiencing an increase in the share of the population that are immigrants and in the share of families without children. In terms of economic changes, the relative importance of manufacturing has declined while services have increased, and the sources of income have changed, with wages and salaries comprising a smaller share of income.

Wallace explores how these trends will exert pressures on the current revenue and expenditure patterns of state and local governments. For example, since the elderly are taxed differently, have different consumption patterns, and obtain their income differently, the growth in the elderly population could have profound effects on the level of state and local revenue and the nature of public expenditure patterns. Thus, as the relative size of the different demographic groups changes, state and local government will face pressures to change their tax systems and their public expenditure patterns. Changes in the structure of the economy and the sources of income have important implications for the growth of the various tax bases. Wallace concludes by offering suggestions for how state and local governments might deal with the pressures they face from these demographic and economic trends.

For the past quarter of a century, the courts have exerted strong influence on state and local government finances, particularly on the provision of education. But the courts are not the only pressure that is likely to have major effects on how education is provided and financed. In Chapter Four, Ross Rubenstein and Lawrence Picus point out that primary and secondary education is going through a transformation as a result of a set of diverse forces. The courts have had a significant effect on the financing of education, and the recent court decisions are having even more profound effects than earlier rulings. But in addition, there are calls for greater autonomy for individual schools and the adoption of new accountability systems which tie funding levels to performance. There are also several market-based alternatives that are creating competition for traditional public (that is, publicly funded) schools. These forces will likely drive major changes in how education is financed and delivered.

In early cases the courts established standards for school finance equity, measured in terms of available resources, for example, equal property tax base per student. Rubenstein and Picus describe the effect that these cases have had on school finances, particularly the equity of school funding. However, for school finance lawsuits that have been decided within the past decade or so, the courts have become more aggressive in specifying remedies and have focused on output, requiring states to ensure that school districts have the level of resources necessary to provide an adequate education. This focus on adequacy represents a substantial alteration in how states will have to think about school finance systems.

While states have responded to equity cases by allocating additional funds to resource-poor school districts, adequacy cases pose the threat of requiring even greater increases in resources, with the amount of resources and their allocation dependent upon how adequacy is measured. The basic foundation program used by many states for education funding determines adequacy in terms of what revenue can be made available from the state budget, while the new standard will be driven by what resources students need. Rubenstein and Picus point out that satisfying issues of adequacy most likely means that current standards for equity cannot be achieved.

Many of the pressures facing public primary and secondary education, namely, accountability systems, market-based alternatives and the demands for change from teachers and parents, focus on the individual school and not the school district. Thus, there is a disconnection between how education is funded, which is district-based, and where the responsibility for the delivery of education is being laid, which is at the individual school level. Rubenstein and Picus discuss these pressures and their implications for the future education finance systems, including how a funding system focused on schools rather than districts might work.

While Fisher (Chapter Two) notes that the last 20 years have been a period of relative stability in state and local government finance, there have been many changes, but as Daniel Mullins suggests in Chapter Five, the changes have been very subtle. Over the past quarter of a century various restrictions have been imposed on state and local governments that limit the use of certain taxes and expenditure levels. Mullins attributes these revenue and expenditure limitations as a major cause of this restructuring, and argues that the limitations will continue to expand, particularly at the state government level.

Mullins argues that the effects of fiscal limitations are not benign and have unintended consequences. The limitations can significantly affect the capacity of governments to provide the public services demanded by citizens. In order to adapt to this imbalance, local governments have had to distort the fiscal and service delivery structures, with the result being a more fragmented and complex state and local public sector and a less responsive one.

Fiscal limitations substantially alter the structure of local finance (for instance by an increase in non-tax sources of revenues) and create shifts in the distribution of service responsibilities between units of government (for instance through the increased role of special service and finance districts). Limitations have reduced the relative role of the property tax, and yielded a property tax that is often at considerable variance with tenets of equity and efficiency, and they are likely to produce a local public sector which is less redistributive in its effects and lead to increased pressures to use privatization and service contracts. Mullins notes that the effects of limitations vary by type of government and service subgroups, and by the demographics of resident populations. He also suggests that the increasing need to adapt to new limitations will likely result in additional fiscal innovation, additional losses in transparency and additional initiatives for reform.

Outside of the role of federal grants, little attention has been paid to the role that federal government policies exert on state and local government finances. Daphne Kenyon (Chapter Six) begins her analysis with a discussion of the many ways that the federal government influences state and local government finances. Federal grants are probably the most significant federal influence on state and local governments. Kenyon notes that while the relative importance of federal grants has not changed in recent years, there has been a major shift to grants that are directed to individuals rather than to places. But there are several other ways in addition to direct assistance through grants that the federal government influences state and local governments. These influences include indirect assistance through the tax code, for example, through the deductibility of taxes and interest on government bonds.

The federal government also has a major effect on state and local government finances through its influence over the national economy, through mandates and via the 'rules of the game'. In the case of the latter influence, the federal government can affect state and local governments not only by passing legislation, but also by choosing to not intervene, for example, by allowing states to compete for economic development activity through tax subsidies and by not addressing the nexus issue associated with sales taxes on internet sales.

How the federal government responds to the return of large federal budget deficits could have major effects on state and local government finances; for example, will the federal government make major changes in grants to subnational governments? There is also the question of whether Congress will enact fundamental tax reform. If it does, it will have major effects on state income tax systems, particularly those that are tied to the federal income tax.

Kenyon goes on to discuss how the role of the federal government has changed and how the 11 September terrorism could alter the relationship between the national and subnational governments. During the 2000 Presidential campaign one news magazine suggested that the candidates appeared to be running for the local school board. But as a result of 11 September, the federal government changed its focus from domestic affairs to international affairs. One possible reaction is that the present focus of the federal government will result in a modification of the current 'fend for yourself' federalism and that we will enter a period of either cooperative federalism or coercive federalism; there is evidence to suggest that either outcome is a possibility.

Advances in information technology have had significant effects on our lives. These same advances are also having substantial effects on government. In Chapter Seven, Kelly Edmiston and William Fox explore how information technology is affecting the provision of public services and changing the tax landscape. Information technology has allowed improved access to many government services. For example, the provision of education, particularly specialized courses and education in more rural areas, has been enhanced by new technologies. And just as information technology has improved efficiency in business, it has the capability to do the same for government. Edmiston and Fox describe the many ways that governments are using new technologies to improve the efficiency of service delivery, for example, by allowing online applications. And the internet has the potential to increase democracy, for instance by providing greater access to information about government and improved access to public decision makers. But Edmiston and Fox suggest that governments are only at the early stages in their use of information technology, and that there are several obstacles, including funding, that have to be overcome in order for state and local government to fully utilize the new technologies.

Information technology has also altered many aspects of business, putting pressures on state and local tax systems. The range of products that can be provided has changed and the physical characteristics of some products can be altered, both of which have consequences for taxes. For example, while a printed version of a book is subject to a sales tax, a digitized version generally is not, and with the ability to order online, a growing percentage of purchases escapes sales tax. In addition, information technology has changed the relative importance of some of the factors associated with business location decisions, perhaps increasing the sensitivity of factors such as taxes. These have consequences for the size and mobility of tax bases such as for the property tax, and for the tax rate that can be imposed without worry that the base will evaporate. Edmiston and Fox point out that these factors will force state and local governments to consider new ways to tax and discuss how state and local governments might respond.

The changes in technology that Edmiston and Fox discuss are part of the reason why state governments face serious challenges regarding the tax and administrative burdens associated with changes in the provision of electricity, natural gas, and telecommunications services. Historically, the three industries operated as regulated monopolies for almost an entire century. But as W. Bartley Hildreth and Bruce Seaman point out in Chapter Eight, the technological change, demand growth, and other developments in the respective industries made this structure inadequate. The deregulation of energy has changed the nature of competition in the industry. In the telecommunications industry the product has evolved into many alternative products provided by many competing firms. The result of these changes in industry structure is a need for states to re-evaluate their tax and public finance systems as they relate to these previously monopoly businesses.

Hildreth and Seaman note that elected officials face considerable complexity as they try to adjust both regulatory and public finance policy to these structural and technological changes. For example, moving toward greater equality in the overall industrial tax burden would require lowering the previously high tax burdens for the newly competitive energy and telecommunications industries. However, without offsetting increases in the overall tax base, or politically unpopular increases in the tax burdens of other sectors, overall tax revenues will decline. Further complications arise since public officials must design legally acceptable taxable relationships (nexus) with newly emergent out-of-state service providers following deregulation. Furthermore, there is no presumption that deregulation of natural gas and electricity, and the technological and structural change in the telecommunications sector, raise exactly the same fiscal issues for all state and local governments.

Hildreth and Seaman suggest labeling states as either 'reform' states or 'coping' states, depending upon whether they adopt policies that represent either a forward-looking (efficiency) or a backward-looking (distribution) focus. A backward looking focus highlights the winners and losers of deregulation, with efforts to design compensatory relief that will redistribute the results along a desired path. This can lead to small policy changes, rather than more fundamental ones. A forward-looking efficiency approach requires the establishment of a 'level playing field' to neutralize taxes as a factor in the competitive interaction among the newly expanded providers of services.

Hildreth and Seaman discuss how various states have responded to this new environment, and do so in the context of a fiscal stress hypothesis, that is, that states facing greater fiscal stress from utility deregulation will be more likely to adopt reform tax policy strategies. The bottom line, however, is that states are taking multiple roads to deregulation and the associated tax reform, and that there is much reform left to be carried out.

Much has been made of the globalization of business and its impact on US businesses. But globalization of the economy also has the potential to have profound influences on state and local fiscal systems. In Chapter Nine, James Alm, Jill Holman and Rebecca Neumann explore this force. As they point out, state and local tax systems were originally designed in an era in which firms produced tangible goods using factors of production that were largely immobile and in which the sale and consumption of these goods were generally performed in the same location. Economic globalization has changed that. Alm, Holman and Neumann describe the various ways that globalization might affect state and local governments and use a stylized model to highlight the probable consequences of the increased mobility that is implied by globalization.

One of the principal characteristics of globalization is the increased mobility of businesses and factors of production. The authors explore how that change affects state and local governments. Greater mobility probably means that competition for the tax base will be more intense. The result is that state and local governments have less autonomy in the design of the fiscal systems they adopt. Alm, Holman and Neumann discuss the likely patterns that might result from this increased mobility, describe how state and local governments will have to adjust their fiscal systems in light of the pressures from globalization and search for any trends that suggest that these patterns are occurring. For example, with increased mobility of some factors of production, we should expect to see a shift away from taxes on more mobile sources.

The more rapid expansion of urban land than of urban population has become a major issue in many urban areas. While sprawl is a topic that has been widely written about, there has been little attention paid to the implications of sprawl for the finances of state and local governments. In Chapter Ten, Therese McGuire and David Sjoquist explore the causes of sprawl, the consequences of sprawl for state and local government finances, and options that state and local governments might adopt to deal with the issue.

As the authors point out, there is no commonly accepted definition of sprawl. However, in designing appropriate policy concerning the geographic expansion of an urban area it is important to separate causes that lead to an economically efficient expansion of the urban boundary from the causes that result in an economically inefficient expansion. Thus, an expansion of an urban area is not necessarily undesirable, but an economically inefficient expansion is. Among the causes that do not necessarily lead to inefficient expansion are increases in population and income, both of which cause the demand for land on the urban fringe to increase. McGuire and Sjoquist identify a host of policies and forces that lead to inefficient expansion of urban areas, including underpricing of the use of roads, property taxation, and the system for financing the expansion of infrastructure.

The expansion of urban areas, whether they are efficient or inefficient, has several consequences for state and local finances, both in terms of the cost of providing public services and in the geographic distribution of tax bases. McGuire and Sjoquist list many of the ways that expansion of the urbanized area can affect the cost of public service delivery and discuss the existing empirical evidence. Finally, they present an extensive discussion of policies for addressing the causes and consequences of the economically inefficient expansion of urban areas. Many of the causes of sprawl are a result of inappropriate market signals, so one set of solutions is to impose proper prices or user fees, an approach which is the standard fare of economists. But McGuire and Sjoquist also discuss other options, including growth management programs such as urban growth boundaries.

There are undoubted other forces and pressures that are driving changes to state and local government fiscal systems, for example the state of the macro economy. But the ones discussed in this volume are certainly some of the most important and persistence pressures forcing structural changes in state and local government fiscal systems. As a result of these pressures, there will likely be substantial changes in the next 25 years in the nature of state and local government fiscal systems.