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# Fiscal Policy in New York and New Jersey: 1977-97

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State and local governments perform essential roles in our federal system, overseeing much of the financing of education, welfare, and public works. In recent years, these responsibilities have grown as the federal government has given more power to the states to determine how public funds should be distributed. The trend is best exemplified by the welfare reform legislation of 1996, which converted federal welfare financing to a fixed block grant and left additional funding entirely to the discretion of the states.[1] Not surprisingly, this and similar changes have created considerable new interest in how states manage their revenues and expenditures.

In this edition of *Second District Highlights*, we explore changes in the size and structure of state and local budgets in New York State and New Jersey between 1977 and 1997. We focus in particular on the evolution of education and welfare expenditures and on the strategies that the two states have adopted to fund these services. We also look beyond the annual spending and revenue flows of New York and New Jersey to consider the change in the states' overall financial status during the period.

Our analysis points to large increases in spending in both states, led by sharply higher outlays for public welfare and education. In both New York and New Jersey, the state government assumed direct responsibility for funding the increase in welfare costs, reducing the role of local government. The two states pursued differing strategies, however, in financing increased education expenditures. While New York boosted state aid to school districts, New Jersey relied heavily on local property taxes to cover the rising costs of education.

As for the overall financial status of New York and New Jersey, we find that neither state made significant gains in the 1977-97 period. Although their budgets were in surplus for most of the period, both states saw long-term debt rise markedly. As a result, *net* financial wealth increased only marginally in New Jersey and declined slightly in New York.

## Overview: New York and New Jersey in a National Context

We begin our analysis of fiscal policy in New York and New Jersey by considering government structure and overall spending in the two states relative to the nation as a whole. Although New York and New Jersey have complex governing structures, the number of governments in both states per million persons is lower than the U.S. average (see table). Counties in New York and New Jersey, for example, average more than 300,000 residents, while the national figure is below 100,000 persons per county.[2] Only New Jersey school districts break with this pattern: The average school district in the state serves about 14,500 persons—compared with 26,500 in New York and 19,000 in the nation as a whole—so the number of school districts is relatively high for the population.

The two state governments also diverge from U.S. averages in their total spending statistics (see table). In both states, direct spending per capita is higher than the national average—$8,775 in New York and $6,390 in New Jersey, compared with the national average of $5,158.[3] New York also exceeds the national average in direct spending as a percentage of personal income, an

**State and Local Governments in New Jersey and New York**

| | New Jersey | | New York | | United States | |
|---|---|---|---|---|---|---|
| | Number | Number per million persons | Number | Number per million persons | Number | Number per million persons, national average |
| Local governments | 1,119 | 140.0 | 2,230 | 122.6 | 49,727 | 188.9 |
| School districts | 552 | 69.1 | 686 | 37.7 | 13,726 | 52.1 |
| General purpose [a] | 567 | 70.9 | 1,544 | 84.9 | 36,001 | 136.8 |
| Special districts | 281 | 35.2 | 1,126 | 61.9 | 36,483 | 138.6 |
| Counties | 21 | 2.6 | 57 | 3.1 | 3,043 | 11.6 |
| Total state/local spending, 1997 (dollars) | 51,078,386 | | 159,571,337 | | 1,357,898,338 | |
| Spending per capita (dollars) | 6,390 | | 8,775 | | 5,158 | |
| Local spending share (percent) | 51.8 | | 61.4 | | 56.8 | |
| Population (7/1/1996 estimate) | 7,993,220 | | 18,184,774 | | 263,256,259 | |
| Average county population | 380,630 | | 319,031 | | 86,512 | |

Sources: U.S. Department of Commerce, Bureau of the Census (1999, 2001)

[a]General purpose governments include cities, townships, and other municipalities.

alternative spending measure that allows one to assess state and local governments' share of overall economic activity. Direct spending amounted to 27.0 percent of personal income in New York, compared with 22.3 percent in the nation as a whole and 18.3 percent in New Jersey.[4] New Jersey spends less than the national average by this measure because personal income in the state is so much higher than in other states.

New York and New Jersey differ sharply in how they divide spending responsibilities between state and local levels ("local spending share" in the table). In New Jersey, state government plays a bigger role relative to localities (including special districts and authorities) than in the nation. In New York, the opposite is true. Even when New York City is excluded from estimates of the local spending share, New York's state-local spending is considerably more decentralized than the national average, although much local spending is financed by the state through aid programs.

## Rapid Growth in Education and Welfare Spending

The period from 1977 to 1997 witnessed large increases in spending by New York and New Jersey's state and local governments, driven largely by rises in education and welfare expenditures (Chart 1). In both states, state governments took on an important role in welfare, either by spending funds directly (New York) or through a combination of direct spending and increased aid to localities (New Jersey). Both states saw education spending—by far the most costly function they perform—rise from approximately $1,500 per capita in 1977 to more than $2,000 per capita by 1997. Those increases were concentrated in elementary and secondary—K-12—school expenditures made by local districts.

The two states differed chiefly in their methods of financing increased spending for K-12 education. In New Jersey, approximately 25 percent of the increase in school spending came from the state, with the balance funded by other school district sources. In New York, by contrast, more than 70 percent of the higher spending came from the state.

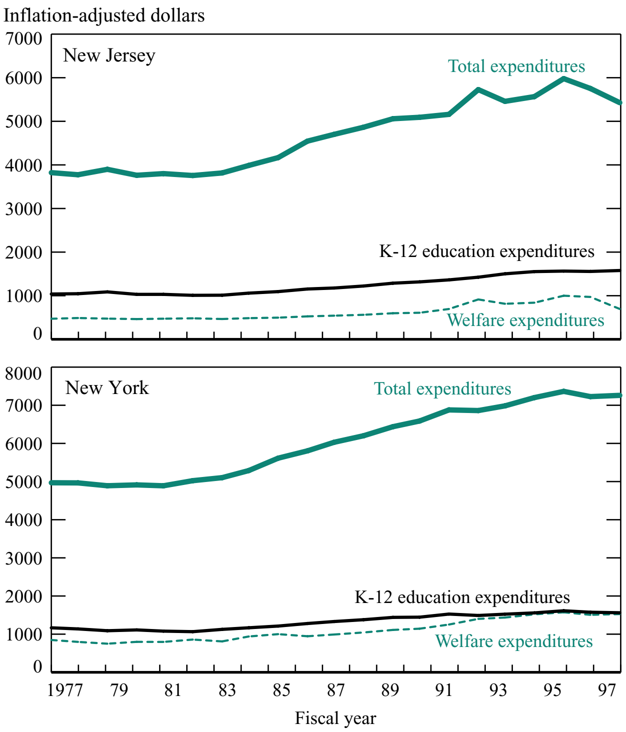
Despite that contrast, overall state and local expenditures followed a similar pattern in New York and New Jersey over the two decades. Although governments in New York consistently spent more than those in New Jersey, the growth rates of the two states' expenditures tracked each other quite closely from 1977 until at least the early 1990s. Overall spending rose 42 percent in New Jersey and 46 percent in New York. Spending was relatively flat at the start of the period (1977-83) and fell slightly at the end (1995-97), and the bulk of increases took place between 1984 and 1994.

### *Education Leads Spending in New Jersey*

In New Jersey (Chart 1, top panel), spending on elementary and secondary education climbed $539 per capita between 1977 and 1997—an increase that

Chart 1

**Real Spending per Capita: New Jersey and New York**




Source: U.S. Department of Commerce, Bureau of the Census (2001).

accounted for more than one-third of the state's total spending rise over the period. Of the $539, approximately $134 came from increased state aid; the balance was funded by local school districts' other revenue sources, primarily local property taxes. Almost all of the increase in both K-12 and total education spending occurred between 1984 and 1994.

New Jersey's spending for public welfare also surged, rising from $472 per capita in 1977 to $1,000 in 1995, before declining caseloads caused a reduction to just under $700 by 1997. Welfare increases were funded directly by state government: local government spending fell from $220 to $160 per capita over the period, while state spending rose from $251 to $535.

Together, spending increases for K-12 education and public welfare in New Jersey totaled $763 per capita, explaining a substantial portion of the overall rise of $1,605 per capita in state expenditures. The remaining spending increases in the state were spread among a variety of functions, with none accounting for a per capita rise of more than $200.

*Welfare Leads Spending in New York*

Education and welfare were also the dominant sources of spending growth for New York State (Chart 1, bottom panel). In New York, however, public welfare spending grew faster than education spending from 1984 to 1994. Over the entire period, total state-local spending in New York grew $2,291 per capita, and public welfare spending rose $679. Spending for K-12 education rose $394 per capita, so together these two functions increased $1,074 per capita. As in New Jersey, spending increases in other functions were widespread and smaller.

In contrast to New Jersey, New York funded the greater part of the increase in education costs by boosting state aid to school districts—on the order of $284 per capita over the period. The shift in welfare responsibility from localities to the state was far more dramatic in New York than in New Jersey. In 1977, New York State directly paid for only 2 percent of public welfare costs in the state. By 1997, it paid 67 percent. Welfare aid from the state to localities declined as the state substituted direct for indirect spending: specifically, aid dropped from about $700 per capita in 1977 (82 percent of state welfare spending that year) to about $475 (31 percent).

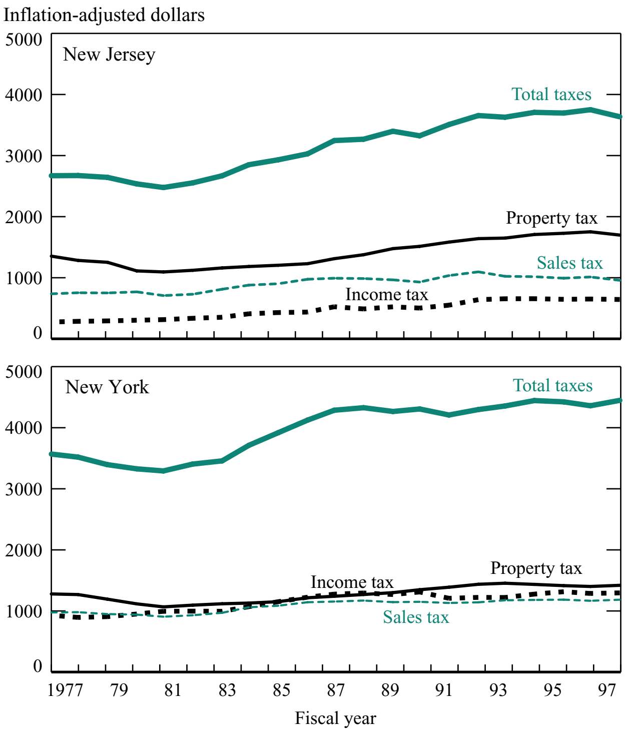
## Shifting Trends in Taxation

Tax structures evolved in strikingly different ways in New York and New Jersey over the 1977-97 period, in large part because of the states' different methods of funding increased education costs. As noted above, New Jersey funded the majority of increases in spending through local property taxes, while New York financed most of the increases from the state tax base. As a result, 36 percent of New Jersey's tax revenue increase between 1977 and 1997 came in the form of property tax revenue; the corresponding figure for New York was 16 percent. By the end of the period, 47 percent of New Jersey's tax revenue came from property taxes, compared with 32 percent for New York.

In 1997 overall, governments in New Jersey collected nearly $3,650 per capita, or 10.5 percent of personal income, in taxes. New York taxes, at about $4,450 per capita, were 13.7 percent of personal income. While both states levy various taxes, those on property, sales, and personal income have historically made up the bulk of tax revenue for both states (Chart 2). Moreover, for both states the property tax is primarily a local tax, while state government claims the majority of sales and income tax revenues.

New Jersey saw its total tax collections per capita peak in 1996, at $3,751. Personal income tax collections

Chart 2
**Real Taxes per Capita: New Jersey and New York**




Source: U.S. Department of Commerce, Bureau of the Census (2001).

per capita, which had grown strongly between 1990 and 1993, were essentially flat thereafter (Chart 2, top panel), and fell slightly as a percentage of personal income.[5] Per capita property tax collections, however, continued to increase until 1996, when they exceeded $1,750, before falling to $1,698 in 1997. In 1997, about 4.9 percent of New Jersey personal income was paid in property taxes. Sales tax collections peaked in 1992, and ended the period at $958 per capita, or 2.8 percent of personal income.

In New York, the personal income tax is a considerably more important revenue source than in New Jersey. Indeed, the income tax exceeded the property tax as a revenue source in New York for a brief period in the 1980s (Chart 2, bottom panel). New York ended the period with higher income and sales taxes but lower property taxes than New Jersey. Property taxes in New York reached their maximum for the period at $1,454 per capita in 1993, a level markedly lower than the New Jersey peak.

## Overall Financial Status of New York and New Jersey

Thus far, we have focused on the annual spending and revenue flows of New York and New Jersey. But to assess the overall financial well-being of these states, we need to consider their saving and borrowing behavior. Financial asset transactions of this kind bear watching because they affect both the long-run stability of government and the health of the state economy.

While it is well known that most states and localities face balanced-budget rules, the fact that those rules generally apply only to the governments' operating budgets is less well understood. The substantial assets and liabilities managed by state and local governments are excluded from widely cited reports on the sector's behavior such as the National Income and Product Accounts (see, for example, Kmitch and Baker [2000]). Governments can in fact be net borrowers while they run surpluses and net lenders while they run deficits. Thus reports of state and local surpluses may convey incomplete information about both the effect of the sector on the economy and the sector's net asset position.

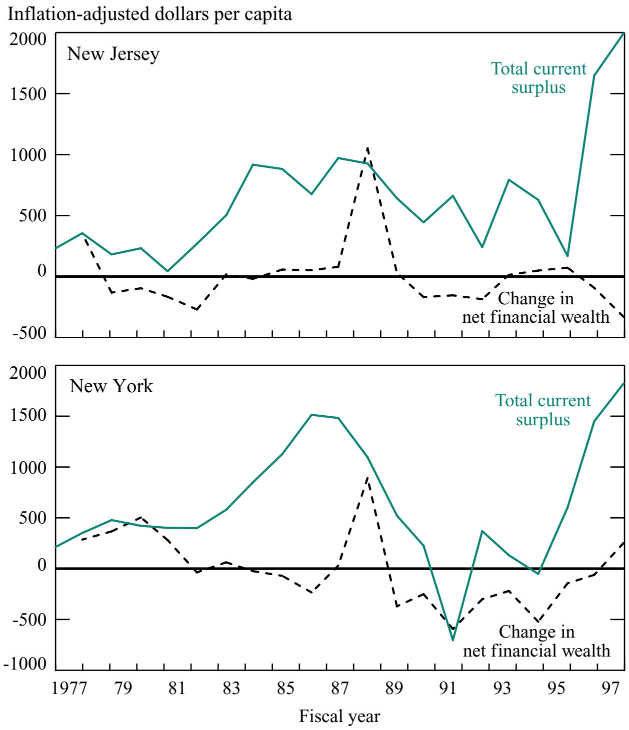
By the typical measure of state and local fiscal policy—the current sector surplus—state and local governments in New York and New Jersey were consistently in the black from 1977 to 1997. But a more comprehensive measure of the sector's financial position—one that combines cash flow and asset accounts to capture net saving and borrowing—yields a less positive picture.

These divergent assessments are brought out in Chart 3. The measure of the sector's current surplus reported in the chart is the difference between total public revenues and total public expenditures, including capital spending. Over the two decades examined, each state ran an average annual surplus on this account in excess of $630 per capita. In New Jersey, the measure was never negative, while in New York it fell below zero only twice, in fiscal years 1991 and 1994.

The second measure shown in the chart—the change in the sector's net financial wealth—includes financial asset transactions such as the drawing down of cash and security reserves and issuing or refunding of long-term debt. This measure is generally negative in both states.[6] Over the period, public debt in real, or inflation-adjusted, terms rose more than $2,100 per capita in New Jersey and about $1,600 per capita in New York. The fact that the sector is enjoying large cash surpluses might lead one to believe that its net wealth is increasing dramatically. Yet New Jersey's net financial wealth

Chart 3

**Two Measures of Financial Health: How New Jersey and New York Fared, 1977-97**




Source: U.S. Department of Commerce, Bureau of the Census (2001).

Notes: The total current surplus is the difference between total state revenues and total state expenditures, including capital spending. Net financial wealth is the value of publicly held assets minus the par value of debt outstanding.

actually increased just $160 per capita over the period, while New York's fell a little more than $150 per capita. Measured in this way, the sector's overall stimulative effect on the economy was relatively small.

Nevertheless, although the increased debt taken on by the states during the period negatively affected their net financial wealth, it enabled them to increase their stock of *physical* capital. Most of this debt was used to finance the acquisition or construction of long-lived capital goods such as prisons, roads, and schools. Indeed, gross physical capital accumulation over these two decades substantially enhanced the net public wealth of both states. In New Jersey, governments invested an annual average of $530 per capita in capital projects gross of depreciation. New York governments' annual gross investment exceeded $750 per capita. Since physical capital, unlike financial assets, depreciates over time, it is difficult to assess how much this gross investment added to the net public capital stock of these states. Still, it is clear that failing to account for these investments in some fashion will understate the accumulation of public wealth by state and local governments.

## Conclusion

The period from 1977 to 1997 witnessed important changes in both the size and structure of state and local fiscal government. Government spending on education and public welfare expanded, prompting an increase in the taxes required to finance those expenditures. In both New York and New Jersey, the state government funded the rise in public welfare spending, while localities played a relatively small role. The two states diverged, however, in their approaches to funding increased education spending.

In New York, state government took the lead, increasing its education aid to local governments by about $0.72 for every dollar in increased K-12 spending. State government in New Jersey contributed only about $0.25 per dollar of increased spending. The predictable result was that New Jersey depended more heavily on property taxes levied almost exclusively by local governments. New York's tax structure remained more diversified, with personal income and property taxes sharing the leading role throughout the period.

Periods of increasing needs like the 1980s and 1990s can easily cause governments to spend more than their tax bases can finance, leading to higher debts or reduced assets. Between 1977 and 1997, real debt outstanding per capita rose in both states, although New Jersey, unlike New York, increased its financial asset holdings at the same time. While both states consistently ran large cash surpluses (with the notable exception of New York in the early 1990s), neither state's public-sector financial position was significantly better in 1997 than in 1977. Three years of strong growth since 1997 may have improved the financial position of state and local governments, but that is far from certain since spending and debt appear to have risen as well. Also uncertain is the state of public-sector physical asset stocks in New York and New Jersey. It is likely, however, that the typical resident of the states in 1997 had access to a more extensive system of public works than he or she did in 1977.

The changes described in this article may provide some useful insight into the future. Investment in education and public works remains near the top of the public agenda, and state and local governments will most likely continue to bear most of the responsibility for these outlays. By contrast, welfare expenditures in the years ahead are much more difficult to predict. If rolls continue to fall as they did during the mid-to-late 1990s, the pressure on state budgets will be minimal. If not, states may face difficult choices between raising state taxes or cutting services. The data indicate that state government will bear this burden, but the possibility remains that local governments may have to contribute as well, as they have in educating New Jersey schoolchildren.

## Notes

1. For a useful discussion of the evolution of federalism, see Inman and Rubinfeld (1997).

2. The inclusion of New York City significantly affects the figures reported in this section. If we exclude the city, with its single school district and large amount of spending per capita and per dollar of personal income, government in New York State conforms more closely to national patterns.

3. Unless otherwise indicated, all dollar figures in this article are reported in constant calendar-year 2000 dollars. New Jersey and New York figures are deflated using the N.Y.–Northern N.J.–Long Island, NY-NJ Consumer Price Index–All Urban Consumers (U.S. Department of Labor, Bureau of Labor Statistics 2001). National data are deflated using the national Consumer Price Index–All Urban Consumers. All revenue items are net of rebates and refunds such as the New York STAR and New Jersey SAVER property tax relief programs.

4. Governments may conduct spending directly or indirectly. Indirect spending involves providing or transferring resources to another government. By using direct spending as our measure, we rule out the possibility of double counting.

5. Note that approximately 4 percent of New Jersey personal income is earned outside the state (U.S. Department of Commerce, Bureau of Economic Analysis 2001, third-quarter data), much of it presumably in New York. Approximately 5 percent of New York personal income, by contrast, is earned by nonresidents. Since income earned by New Jersey residents working in New York is subject to taxation by New York, total personal income overstates the available tax base in New Jersey while understating it in New York. New Jersey tax collections as a share of personal income ignore taxes paid to New York, understating the true tax rate paid by New Jersey residents and overstating New York's rate.

6. The obvious exception is fiscal year 1988, when state and local governments across the country were required to come into compliance with new Internal Revenue Service regulations under the 1986 tax reform. In response, both New York and New Jersey substantially increased the balances in their debt-offset (sinking) funds.

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