

RICH STATES, POOR STATES: ASSESSING THE DESIGN AND EFFECT OF A U.S. FISCAL EQUALIZATION REGIME

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Unlike most of the world's federations—including Australia, Canada, Germany, India, South Africa and numerous others—the United States has no system of federal equalization grants in place to reduce fiscal disparities among its subnational governments. Only at the state level, through policies designed to mitigate property tax disparities among school districts, has equalization been tried in the United States. The federal government has never adopted, nor has it ever seriously considered, an equalization policy for the states. This article represents the first comprehensive scholarly treatment of a possible U.S. fiscal equalization regime. It reviews the most recent data relating to fiscal disparities among the U.S. states and reports the results of simulations showing the overall cost and distributive effects of adopting a Canadian-style equalization regime in the United States. Two alternative policies are examined, one based on the “representative tax system” methodology employed in Canada and a second, known as the “representative revenue system,” that employs a slightly broader measure of state fiscal capacity. Depending on the methodology employed, the cost of a U.S. equalization policy (based on 2005 data) would be in the range of \$70-\$110 billion per year, or roughly 1 to 1.5 times the annual cost of the current income tax deduction for state and local taxes. Under both methodologies, as well as alternative formulas adjusting for regional cost-of-living differences, the principal beneficiaries would be the so-called “red states” of the South. On a per capita basis, the main winners of a U.S. equalization policy would be Mississippi, Arkansas, and West Virginia. In terms of absolute payments, the largest beneficiary is by far Texas, accounting for approximately 15 percent of total equalization payments. The article considers arguments for and against adoption of an equalization policy and offers some preliminary comments on the politics of fiscal equalization in the U.S. context.

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INTRODUCTION

Among the world's federations, the United States is an extreme outlier with regard to the efforts undertaken by the national government to equalize the taxing capacity of subnational jurisdictions.¹ Australia, Canada, Germany, India, South Africa, and numerous other federations throughout the world have in place a complex system of "equalization grants" whereby the central government makes fiscal transfers to ensure that resources available to state or provincial governments do not exhibit significant variation.² In many cases, these equalization policies are written into the nation's constitution. For example, Section 36 of the Canadian Constitution envisions federal equalization policies designed "...to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public service at reasonably comparable levels of taxation."³

The United States has no such system.⁴ As a consequence, states with fewer economic resources (e.g., Arkansas, Mississippi, West Virginia) must exert greater fiscal effort in order to provide government services on a par with wealthier states (e.g., Connecticut, Delaware, Massachusetts).⁵ To take just one data point, consider that Connecticut's total per capita revenue capacity for 2005 was \$7,205, while the same figure for Mississippi was \$3,784. These figures represent the amounts that each state could hypothetically raise if it were to impose an average

¹ Michael Keen, *Peculiar Institutions: A British Perspective on Tax Policy in the United States*, 50 NATIONAL TAX JOURNAL 779 (1997) (describing equalization policies of several countries and concluding that the "United States stands alone among the federations of the advanced economies in its failure to equalize across the states.")

² Discussions of the fiscal equalization regimes in these countries can be found in INTERGOVERNMENTAL FISCAL TRANSFERS: PRINCIPLES AND PRACTICE (edited by Robin Boadway and Anwar Shah, 2007). See, in particular, Chapter 9, Sujit Choudhry and Benjamin Perrin, *The Legal Architecture of Intergovernmental Transfers: A Comparative Examination*, at 259-292, and Chapter 10, Anwar Shah, *Institutional Arrangements for Intergovernmental Fiscal Transfers and a Framework for Evaluation*, at 293-317 (discussing equalization policies in named countries and numerous others).

³ Part III, *Equalization and Regional Disparities*, Section 36, The Constitution Act of Canada (1982) (available at <http://laws.justice.gc.ca/en/const/index.html>).

⁴ This is not to suggest that federal tax/transfer policies have no interstate or interregional distributive effects. For example, the federal government draws more resources from high-income states than low-income states via the operation of the federal income tax. As discussed *infra*, however, these policies raise distinct concerns.

⁵ Data on relative tax and revenue capacity are discussed *infra* at Part II.A.

set of tax rates on a standard set of tax bases. In fact, however, Connecticut collected \$6,630 per capita with an overall revenue effort lower than the national average, while Mississippi raised \$4,092 per capita with a revenue effort higher than the national average.⁶ That is, despite exerting greater fiscal effort, Mississippi raised \$2,538 less than Connecticut.

Public finance theorists have long criticized such fiscal disparities, contending that they implicate both fairness and efficiency concerns. On the question of fairness, proponents of fiscal equalization argue that “the fiscal treatment given by lower level jurisdictions should be the same for individuals in equal positions, independent of the jurisdiction in which they reside.”⁷ This same principle can be expressed as an efficiency norm. Where otherwise similarly situated individuals are given different fiscal treatment simply because of where they live, an incentive exists for individuals to migrate in search of greener fiscal pastures. Such “fiscally-induced migration” as it is sometimes called, generates deadweight loss for society by distorting locational decisions. Thus, to the extent that interjurisdictional fiscal disparities lead to fiscally-induced migration, equalization policies may also be justified on welfarist grounds.

While arguments of fairness and efficiency have dominated the academic literature in this area, in practice the driving force behind fiscal equalization grants has always been raw politics. In most federations, equalization transfers are part of the political “glue” holding the country together. It is no coincidence that the province of Quebec, home to a longstanding separatist movement, is the chief beneficiary of Canada’s

⁶ The term “effort” here is used to describe the difference between the amount of revenues the state actually raised and the amount it would have raised if it had applied average tax rates to a standard set of tax bases. For 2005, Connecticut raised revenue equal to 87 percent of what it would have raised using average tax rates, while Mississippi raised 108 percent of what average tax rates would have raised. While these two states represent the extremes, the phenomenon holds true across all fifty states. Despite comparable revenue effort, the top 25 wealthiest states raised an average of \$5,863 per capita in 2005, while the bottom 25 raised \$4,692 per capita.

⁷ Peter Mieszkowski & Richard Musgrave, *Federalism, Grants, and Fiscal Equalization*, 52 NAT’L TAX J. 239 (1999) (attributing the horizontal equity argument to Buchanan, in James M. Buchanan, *Federalism and Fiscal Equity*, 40 AM. ECON. REV. 583 (1950)).

equalization program.⁸ Likewise, revisions to the German equalization scheme since 1990 were not prompted by a rethinking of fairness and efficiency norms but rather were part of the political give and take necessary to bring the new East German *Länder* into the federation.⁹ The point here is not that equalization lacks a normative mooring; however, like all complex policy issues in a democracy, the allocation of intergovernmental transfers is inescapably political.

Whatever the reasons for adopting fiscal equalization, the policy is not without its costs. Beyond the explicit budgetary expense involved, equalization policies are notoriously complicated and difficult to administer.¹⁰ Even just determining which states are “rich” and which are “poor” is a question beset with technical complexity, not to mention political controversy.¹¹ In Canada, for example, the equalization program has undergone numerous reforms over the years, with provinces continually jockeying for a more advantageous position in the distribution of federal equalization dollars. In addition, poorly designed equalization policies can create perverse incentives by partially insulating provincial governments from the fiscal consequences of their actions.¹² Fiscal equalization policies may also disrupt the Tieboutian “market” in

⁸ See Doug Struck, *Separatists Slip in Quebec Vote*, WASH. POST (March 27, 2007) (describing Quebec’s separatist movement and noting Ottawa “handed the province an extraordinary windfall worth about 2 billion U.S. dollars in the form of a tax “equalization” system to try to pacify Quebecers.”)

⁹ Wolfgang Renzsch, *Financing German Unity: Fiscal Conflict Resolution in a Complex Federation*, 28 PUBLIUS 127 (1998).

¹⁰ This is a frequent complaint regarding Canada’s equalization program. See, e.g., Jack Mintz, *Provincial Fiscal Equalization and Territorial Formula Financing: Expert Review Panel Consultation at the C.D. Howe Institute, June 10, 2005, Rapporteur’s Comments* 6 (2005) (noting that Canada’s system is “too complex and, as a result, undermines transparency.”). See also Gregory P. Marchildon, *Understanding Equalization: Is it Possible?*, 48 CANADIAN PUBLIC ADMINISTRATION 420 (2005).

¹¹ For a discussion of alternative methods of measuring fiscal capacity, see H. CLYDE REEVES (ED.), *MEASURING FISCAL CAPACITY* (1986). The now defunct Advisory Commission on Intergovernmental Relations (ACIR) also published several studies of alternative measures of fiscal capacity.

¹² Michael Smart & Richard Bird, *Federal Fiscal Arrangements in Canada: An Analysis of Incentives*, NATIONAL TAX ASSOCIATION PROCEEDINGS (1996) (suggesting that equalization grants may lead recipient governments to adopt more distortionary taxes than they would in the absence of the grants).

state and local public goods, arguably eclipsing some of the benefits of the decentralized form of government.¹³

This article will examine the arguments for and against adopting a Canadian-style equalization regime in the United States, as well as the political and historical context of the current U.S. “no equalization” policy. The article is divided into three parts. Part I provides a brief review of the principal arguments in support of equalization grants and then examines the equalization problem in the familiar (to the U.S. experience) context of school finance reform. While the problem of fiscal disparities among school districts is conceptually similar to the problem of fiscal disparities among states, it is suggested that the latter presents far greater complexity and consequently requires a different policy response. Part I also offers a brief overview of the equalization programs in Canada and Australia to illustrate the practical operation of an equalization policies at the federal level.

Part II will examine the most recent data concerning fiscal disparities among the U.S. states, with an emphasis on alternative methodologies for measuring such disparities. Focusing specifically on the “representative tax system” approach employed in Canada, this Part will also provide details regarding the chief source of interstate fiscal disparities by disaggregating the RTS measure into its constituent parts. Not surprisingly, fiscal disparities in the United States are chiefly a function of differences in the three major sources of state and local tax revenue: the personal income tax, the property tax and the retail sales tax. Part II then considers what effect current U.S. federal grant programs have on mitigating those disparities.¹⁴ That is, despite the absence of an explicit equalization program in the United States, are federal grants currently allocated in a manner that benefits states with low fiscal capacity? Based on a review of earlier studies and an examination of more recent data on this question, it is shown that existing federal grant programs do not have

¹³ By partially insulating subnational governments from the fiscal effects of taxpayer exit, equalization grants could reduce the efficiency benefits (if any) of local provision of public goods. See Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416-24 (1956).

¹⁴ Federal grants to state and local governments figure prominently in the U.S. federal budget, accounting for approximately 17 percent of outlays in FY2006. Donald Boyd, *2006 Rockefeller Institute Reports on State and Local Government Finances*, ROCKEFELLER INSTITUTE OF GOVERNMENT (May 2006).

an equalizing effect and in many instances direct greater federal resources to states with higher fiscal capacity. To illustrate the dynamics underlying these results, Part II provides an overview of the nation's largest intergovernmental grant program, Medicaid, and the operation of the statutory formula for Federal Assistance Medical Percentages (FMAP) that determines Medicaid grants to the states.

Part III reports the results of two simulations showing how a fiscal equalization program modeled on the Canadian system would work in the United States. Because of differences in the U.S. and Canadian tax systems, it is not possible to perfectly replicate the Canadian system in the United States. However, using recently released data on the relative fiscal capacity of all 50 states, it is possible to get a rough idea of what a U.S. fiscal equalization program would look like. The two approaches examined are based on the "representative tax system" (RTS) and "representative revenue system" (RRS) methodologies. It is shown that, depending on the system adopted, an equalization policy for the United States would have an annual cost to the federal budget of approximately \$70-\$110 billion, with roughly two-thirds of the states receiving some equalization payment. The main beneficiaries of a U.S. equalization program, using either methodology, are concentrated in the Southeastern region of the country, including the states of Mississippi, West Virginia, Arkansas, Alabama, Louisiana and South Carolina. In short, adoption of a Canadian-style equalization program in the United States should be understood as a policy that would principally benefit the so-called "red states" of the South.

The article concludes with a brief discussion of the politics of fiscal equalization in the U.S. context. Unlike other federations that have adopted equalization policies, the United States is under no threat of secession or other sectional crisis that might motivate such a reform to the country's intergovernmental fiscal arrangements. However, the cluster of poor states that stand to benefit most from an equalization regime represent a key (and growing) electoral prize in American politics.¹⁵ If equalization is to gain a political footing in the United

¹⁵ BOB MOSER, *BLUE DIXIE: AWAKENING THE SOUTH'S DEMOCRATIC MAJORITY* 6 (2008) (noting that by "the 2032 elections, the U.S. Census Bureau projects that the South will control almost 40 percent of the electoral vote for president—more than the declining Northeast and Midwest *combined*.").

States, the most likely path would be through the efforts of political entrepreneurs using it as a policy reform designed to win the allegiance of that region's voters. Of course, equalization is not the exclusive policy tool available to these entrepreneurs, perhaps not even the most effective; yet it may offer promise as a high-visibility reform that signals the arrival of a new "post-partisan" approach to designing U.S. institutions of fiscal federalism.

I. FISCAL EQUALIZATION IN THEORY AND PRACTICE

Unlike unitary governments, federations allocate responsibility for the provision and financing of public goods among different levels of government, typically by dividing a country into geographic subunits. This decision inevitably gives rise to fiscal disparities, since economic resources are not distributed uniformly among subnational political jurisdictions. Whether by virtue of deliberate government policies or historical happenstance, some states will have larger amounts of taxable resources than others. The practical effect of this disparity in tax bases can be viewed from the perspective of the *unequal revenues* generated by the imposition of an equal tax or the *unequal tax effort* required to generate a comparable amount of revenues.

To illustrate, consider a hypothetical country with two states, Poor State and Rich State, which have total tax bases of 1,000 and 5,000, respectively. For the moment, let us assume some generic tax base, without reference to specific alternatives (income, property, sales, etc...). Focusing on revenues, we might observe that a 10 percent tax imposed by both jurisdictions would generate 100 of revenue in Poor State and 500 of revenue in Rich State. Alternatively, focusing on tax effort, we can say that raising 200 of revenue would require a 20 percent tax in Poor State but only a 4 percent tax in Rich State.¹⁶ Thus, depending on

¹⁶ Note that "tax effort" here is the amount of revenue raised as a percentage of the total tax base available. Conceptualizing equality of effort in this manner privileges the chosen tax base as the appropriate measure of effort. For example, assume that the 1,000 and 5,000 figures mentioned in the text represent the total value of real property within the two states. Further assume that each state has total *income* of 2,000. With that additional information, the fact that Poor State must impose a property tax rate five times the rate imposed by Rich State seems less objectionable since both jurisdictions are raising 10 percent of their income through taxes. The point here is that the language of interjurisdictional fiscal equalization is subject to many of the same controversies

the policy choices made by the two governments, fiscal disparities may prompt objections from Poor State taxpayers (who feel they are bearing an unfair tax burden compared to their Rich State counterparts with identical private incomes) or beneficiaries of Poor State spending programs (who believe those programs are being inadequately funded as compared to Rich State programs). As a practical matter, both effects are likely to be in evidence, with Poor State taxpayers feeling overtaxed even as public programs in the state are underfunded as compared to wealthier jurisdictions.

A. *Fairness and Efficiency Rationales for Fiscal Equalization*

While Poor State objections to fiscal disparities are easy enough to see, the policy rationale for alleviating them requires further elaboration. Within the academic literature, much of the discussion of this question can be traced to an article published in 1950 by Nobel Prize-winning economist James Buchanan.¹⁷ Whereas previous authors had argued for fiscal equalization grants on the grounds of equal treatment of the states themselves, Buchanan contended that “equality in terms of states is difficult to comprehend, and it carries with it little ethical force for its policy implementation.” As Buchanan saw it, interstate differences in fiscal capacity were relevant only insofar as they “can be traced through to their ultimate impact upon individuals...” Thus, “the policy objective for intergovernmental transfers then becomes one, reduced to individual terms, of providing or ensuring ‘equal fiscal treatment of equals.’”¹⁸

The intuition underlying Buchanan’s analysis can be illustrated through a simple example. Assume that individuals A and B have the same income and are in every respect identical, except that A is the poorest member of a wealthy community and B is the wealthiest member of a poor community. In a unitary government, the differential composition of the two communities has no bearing on the fiscal position of A and B. They are treated the same, as principles of horizontal equity would seem to require. In a federation, however, where some subset of

and debates as the language of interpersonal redistribution. Before evaluating fairness claims, one must first defend the metric on which one is comparing jurisdictions.

¹⁷ See Buchanan, *supra* note 7. For a more recent treatment of the subject by Buchanan, see James M. Buchanan, *Fiscal Equalization Revisited: Welfare Trap or Helping Hand?* (April 2002) (available at <http://www.aims.ca/library/fiscal.pdf>).

¹⁸ Buchanan, *supra* note 7 at 591.

governmental responsibilities is allocated to the communities in which A and B live, this equality of treatment is disrupted by the differences in taxable resources available to the two communities. Unless the communities rely on perfect benefit taxation, whereby each individual pays an amount in taxes equal to the value of public services consumed, B will be treated less favorably than A. That is, taxpayer B will either bear a greater tax burden for a given level of government spending or will enjoy fewer government services for a given level of taxes. In effect, the decision to draw jurisdictional lines around groups of people results in different fiscal treatment for otherwise similarly situated individuals. In Buchanan's view, the principal justification for fiscal equalization grants is to eliminate that differential fiscal treatment. With appropriately crafted intergovernmental transfers, "persons earning the same income and possessing the same amount of property will no longer be subjected to a much greater fiscal pressure in Mississippi than in New York, solely because of residence in Mississippi."¹⁹

The "equal treatment of equals" is not the sole objective of fiscal equalization. The existence of fiscal disparities may also give rise to efficiency concerns.²⁰ Here the idea is that central government intervention is appropriate so as to minimize fiscally induced migration—i.e., migration undertaken to capture net fiscal benefits (NFBs) available in other jurisdictions.²¹ Indeed, as discussed further below, the whole question of fiscal equalization can be seen as an effort to eliminate (or reduce the influence of) NFB differentials among subnational jurisdictions.²² NFB differentials can arise either from differences among jurisdictions in the availability of source-based taxes (e.g., natural resource revenues) or from redistributive residence-based taxes (e.g., personal income taxes).²³ Stated more generally, whenever

¹⁹ *Id.*

²⁰ See Buchanan, *supra* note 7. See also Buchanan, *Federal Grants and Resource Allocation*, 60 JOURNAL OF POLITICAL ECONOMY 208 (1952); Robin Boadway & Flatters, *Efficiency and Equalization Payments in a Federal System of Governments: A Synthesis and Extension of Recent Results*, 15 CANADIAN JOURNAL OF ECONOMICS 613 (1982).

²¹ Helen Ladd, *Fiscal Equalization*, in ENCYCLOPEDIA OF TAXATION AND TAX POLICY 145-146 (Joseph J. Cordes, Robert D. Ebel & Jane G. Gravelle, eds., 2002).

²² Robin Boadway, *Equalization Revisited: Its Role and Design* 8 (2001) (the "ultimate sources of fiscal inefficiency and fiscal inequity are NFB differences for like residents in two different provinces.") (http://www.arts.uregina.ca/drupal/dbfm_send/178).

²³ *Id.* at 8-9.

subnational jurisdictions rely on anything other than perfect benefit taxation, NFB differentials will be present, creating incentives for fiscally-induced migration and distorted locational decisions.

One might think that migration induced by fiscal differences should not be discouraged. After all, the ability of taxpayer to “exit” a jurisdiction in search of greener fiscal pastures is often thought to be an efficiency-*enhancing* feature of decentralized systems of government. As originally shown by Tiebout, the combination of consumer mobility and competition among local governments can lead to an efficient local public sector, as individuals and businesses shop among jurisdictions in search of the package of taxes/services that most closely approximates their preferences.²⁴ The intuition behind the Tiebout model is that the choice of jurisdiction serves as a mechanism by which taxpayers reveal their preferences for the level of public goods. In a pure Tiebout model, however, all local public goods are financed by price-like benefit taxes.²⁵ That is, the Tiebout model assumes that there are no NFB differentials. Once that assumption is relaxed and variation in fiscal capacities is introduced, individuals may choose to migrate simply to improve the terms of fiscal exchange—a process that economist Bruce Hamilton once colorfully referred to as “musical suburbs, with the poor following the rich in a never-ending quest for a tax base.”²⁶ Thus, the presence of NFB differentials disrupts the otherwise efficiency-enhancing properties of the multijurisdictional setting.

For example, taxpayer B above, who is a net fiscal transferor within his current community, may wish to move to taxpayer A’s community, where he would be a net fiscal transferee. Because migration offers more advantageous terms of fiscal exchange, B’s decision to move to A’s

²⁴ Tiebout, *supra* note 13.

²⁵ See description in Kirk J. Stark & Jonathan Zasloff, *Tiebout & Tax Revolts: Did Serrano Really Cause Proposition 13?*, 50 UCLA L. Rev. 801 (2003). See also John D. Donahue, *Tiebout? Or Not Tiebout? The Market Metaphor and America’s Devolution Debate*, 11 J. ECON. PERSP. 73 (1997).

²⁶ Hamilton’s extension of the Tiebout model incorporated property taxes in lieu of head taxes, thus introducing the complication of fiscal disparities and the corresponding potential for tax-induced migration. He suggested, however, that communities may use zoning rules as a means of regulating the amount of tax base that incomers must consume in order to gain entry to the community. See Bruce Hamilton, *Zoning and Property Taxation in a System of Local Governments*, 12 URBAN STUDIES 204-211 (1975).

community is no longer a reliable indicator of his true preferences. Rather, he may be simply trying to capture the fiscal benefits made available (or avoid the costs imposed) as a result of the manner in which jurisdictional lines have been drawn around various communities. Accordingly, migration is no longer a trustworthy mechanism for revealing taxpayer preferences. As Buchanan put it, “the whole fiscal structure should be as neutral as is possible in a geographic sense. An individual should have the assurance that wherever he should desire to reside in the nation, the over-all fiscal treatment which he receives will be approximately the same.”²⁷ Here again, then, we see an argument for fiscal equalization grants. By reducing fiscally induced migration, equalization can be justified on welfarist grounds.

B. *What Fiscal Equalization Is and Is Not*

As the foregoing discussion suggests, the principal objective of a fiscal equalization program is the *elimination of net fiscal benefit differentials* among subnational units of government. In practice, of course, it is very unlikely that a system of fiscal equalization grants can completely eliminate NFB differentials. More realistically, one might describe fiscal equalization as designed to minimize the adverse effects (in terms of fairness or efficiency) of NFB differentials among a federation’s subunits. It may be useful to think of the objective as replicating, to the greatest extent possible, the geographic fiscal neutrality that would obtain if the country were organized as a unitary government rather than as a federation. In effect, by creating NFB differentials, the decision to organize a country as a federation operates as a system of commodity taxes—conferring differential fiscal treatment on citizens with identical private incomes depending on their locational decisions.²⁸ The easiest way to eliminate this differential fiscal treatment is to organize the country as a unitary government rather than a federation. Fiscal equalization grants can be viewed as an attempt to “have your cake and eat it to”—i.e., an effort to maintain the benefits of federalism (chiefly decentralized political decision-making) while minimizing the adverse fiscal effects associated with the decision to divide the country into geographic subunits.

²⁷ Buchanan, *supra* at 589.

²⁸ On the general undesirability of differential commodity taxation, see LOUIS KAPLOW, *THE THEORY OF TAXATION AND PUBLIC ECONOMICS* 127-135 (2008).

Viewing NFB differentials as the ultimate target of fiscal equalization helps to clarify which federal policies might potentially serve an equalization function and which do not. Most importantly, it bears noting that federal tax or spending policies should not be regarded as substitutes for an equalization regime simply because those policies have disparate geographic effects. This point deserves special emphasis because of the common tendency to describe the geographic distribution of federal fiscal policies in terms of “donor states” and “beneficiary states.” For example, each year the Tax Foundation publishes a report titled *Federal Tax Burdens and Expenditures by State*, which purports to describe “which states are the biggest beneficiaries of federal fiscal operations and which are the so-called donor states.”²⁹ Given this language, it is tempting to assume that these findings are relevant to the question of fiscal equalization. In fact, however, the Tax Foundation report raises a very distinct set of issues. On the spending side, for example, the report’s conclusions regarding which states are “beneficiaries” and which are “donors” rely on census data regarding the geographical distribution of things such as government salaries, wages, and procurement contracts. Not surprisingly, the two states that border the nation’s capital—Virginia and Maryland—are consistently among the chief “beneficiaries” of federal spending in these categories. Virginia in particular stands out in the Census Bureau’s *Consolidated Federal Funds Report* (from which the Tax Foundation derives its data) because of its number one ranking for per capita federal spending on Department of Defense procurement contracts.³⁰

While this information is worthy of public debate, the fact that certain federal outlays are disproportionately concentrated in certain states has no direct bearing on the presence or absence of NFB differentials or the question of fiscal equalization. Recall the hypothetical country discussed above, with two states, Poor State and Rich State, which have total tax bases of 1,000 and 5,000, respectively. A decision by this country to locate its national defense headquarters in Poor State might have some *indirect* effect on the NFB differentials between the two jurisdictions—

²⁹ Curtis S. Dubay, *Special Report: Federal Tax Burdens and Expenditures by State—Which States Gain Most from Federal Fiscal Operations?*, TAX FOUNDATION (March 2006).

³⁰ Table 5, *Federal Government Expenditure for Procurement Contracts, by Agency, by Outlying Area: Fiscal Year 2006*, U.S. CENSUS BUREAU, CONSOLIDATED FEDERAL FUNDS REPORT FOR FISCAL YEAR 2006 8-11 (April 2008).

perhaps by increasing the Poor State tax base from 1,000 to 1,500 through the location of private firms serving the national defense establishment. But aside from these indirect effects, the fact that the federal government is “spending more in Poor State” (by, say, entering into contracts with private firms headquartered in Poor State) has no effect on the fiscal terms of exchange that Poor State residents confront when financing state and local public goods. The object of fiscal equalization is not to ensure a particular geographic distribution of federal spending, but rather to ensure that the federation’s political subunits can, with comparable tax effort, generate comparable spending on state and local programs.

A similar analysis applies to the geographic distribution of federal tax burdens. It is well known that federal tax burdens vary significantly across different regions of the country. Not surprisingly, given that the federal revenue structure is dominated by income and payroll taxes, the per capita federal tax burden is higher for high income states than it is for low income states. For example, the Tax Foundation report notes that Connecticut had a per capita federal tax burden of \$10,570 in 2004 while Mississippi’s per capita federal tax burden was only \$4,046.³¹ Like federal spending, however, these state-by-state differences in per capita federal tax burdens have no effect on the NFB differentials faced by individual taxpayers with respect to the financing of state and local public goods. In the U.S. tax system, an individual’s federal tax liability is not a function of her state’s relative fiscal capacity.³² Thus, a lawyer earning a \$100,000 salary will generally bear the same federal tax burden whether she lives in a rich state or a poor state.³³ In other words, federal taxes do not compensate taxpayers for NFB differentials arising from interstate fiscal disparities. Accordingly, differences in per capita federal tax burdens do not meet Buchanan’s requirement of giving an individual the “assurance that wherever he should desire to reside in the nation, the

³¹ Dubay, *supra* note 29 at 5.

³² Section 164 of the Internal Revenue Code, which allows a deduction for state and local taxes, influences the tax price faced by taxpayers in financing state and local public goods; however, it does not adjust federal tax liability on the basis of relative state fiscal capacity.

³³ If anything, such a lawyer’s federal tax liability may actually be lower in a rich state (e.g., Connecticut) because of the deductibility of state and local taxes, which are generally higher in rich states than in poor states.

over-all fiscal treatment which he receives will be approximately the same.”³⁴

C. *Fiscal Equalization and School Finance Reform in the U.S.*

The arguments described above have figured prominently in the longstanding debate over property tax disparities and school finance reform in the United States. Historically, most American states have relied on local property taxes as the principal source of revenue for public schools. Because of interjurisdictional differences in the value of taxable property, school districts commonly exhibit variation either in per pupil expenditure levels or in the tax rates imposed on local property owners. Litigation concerning the constitutionality of these disparities traces back to the pre-Civil War era, including an important Indiana Supreme Court decision, *Greencastle Township v. Black*, which was handed down in 1854.³⁵ More recently, beginning in the 1960s, fiscal disparities among school districts have prompted several constitutional challenges in both state and federal court.³⁶

Consider the landmark school finance case out of California, *Serrano v. Priest*.³⁷ In that litigation, parents of children in schools located in certain of the state’s poorer school districts challenged the constitutionality of the state’s reliance on local property taxes as the primary means of school funding. The crux of the argument was that differences in per pupil assessed valuation across school districts gave rise to differences in per pupil spending and property tax rates that were so severe as to constitute a violation of the equal protection clauses of the federal and state constitutions. The California Supreme Court agreed, concluding that the state’s reliance on local property taxes did in fact violate the state equal protection clause.³⁸

³⁴ Buchanan, *supra* note 7 at 589.

³⁵ For a discussion of this case and the later decision overruling it, see Kirk J. Stark, *Rethinking Statewide Taxation of Nonresidential Property for Public Schools*, 102 *YALE L. J.* 805 (1992).

³⁶ *Id.* at 805-806.

³⁷ *Serrano v. Priest*, 487 P.2d 1241 (1971) (“*Serrano I*”); *Serrano v. Priest*, 557 P.2d 929 (“*Serrano II*”); *Serrano v. Priest*, 200 Cal. App. 3d 897 (1986) (“*Serrano III*”).

³⁸ The California Supreme Court had originally held that the disparities also violated the federal equal protection clause. However, the federal equal protection argument

At its core, the *Serrano* case boiled down to a comparison of the fiscal capacity of “rich” districts and “poor” districts, with Beverly Hills and Baldwin Park representing the two extremes. The original opinion in *Serrano v. Priest* nicely captures the effect of tax base disparities on both taxpayers and school spending beneficiaries. In the landmark 1971 decision, Justice Sullivan noted that the Beverly Hills School District spent a total of \$1,232 per pupil at a tax rate of \$2.38 per \$1,000 of assessed valuation, while Baldwin Park spent \$577 per pupil at a tax rate of \$5.48 per \$1,000 of assessed valuation.³⁹ In other words, with a tax rate of more than twice the rate in Beverly Hills, Baldwin Park was able to raise less than half the revenues. Implicit in the *Serrano* analysis, with its emphasis on the disparity in tax rates between rich and poor districts, is an endorsement of the principle that comparable tax effort should generate comparable revenues, regardless of the value of the underlying tax base. In other words, *Serrano* and cases like it stand for the proposition that public school expenditures should be a function of a community’s willingness to tax itself but not a function of the assessed valuation of the district’s taxable property.

Perhaps the most prominent proposal to put this principle into practice is the “district power equalization” (DPE) idea, which was originally advanced by Professors Coons, Clune and Sugarman in their book, *Private Wealth and Public Education*, published in 1970.⁴⁰ The essence of the DPE methodology was to guarantee an equal tax base to each school district so that variation in local spending would be a function only of tax effort and not the value of the tax base.⁴¹ This is done through the use of state grants the amount of which varies depending on local tax effort and the difference between the guaranteed tax base and the district’s actual tax base.

was rejected in a separate case decided by the U.S. Supreme Court in 1973. *San Antonio v. Rodriguez*, 411 U.S. 1 (1973).

³⁹ *Serrano v. Priest*, 487 P.2d 1241 (1971).

⁴⁰ JOHN E. COONS, WILLIAM H. CLUNE, III, & STEPHEN D. SUGARMAN, *PRIVATE WEALTH AND PUBLIC EDUCATION* 202 (1970) (observing that “a power equalizing system operates by making dollars per pupil a function of effort alone.”).

⁴¹ For a basic description of the DPE methodology, see COONS, CLUNE, SUGARMAN, *supra*, at 204-212. See also Andrew Reschovsky, *Fiscal Equalization and School Finance*, 47 NAT’L TAX J. 185, 187-189 (1994).

For example, assume that the guaranteed tax base is \$50,000 of assessed valuation per pupil and that Poor District, with a tax base \$40,000 per pupil, chooses to impose a 5 percent property tax. Without equalization, Poor District would raise \$2,000 per pupil with a 5 percent tax. Under the DPE system, by contrast, Poor District would be entitled to state aid equal to \$500 per pupil, bringing its total spending up to \$2,500.⁴² Note that under the DPE approach, low capacity districts can also increase their equalization grants by increasing local tax effort. Thus, if Poor District in our example above were to impose a 6 percent tax rate, its equalization payment would increase from \$500 to \$600 per pupil. In practice, statutory DPE formulas are substantially more complex and often incorporate floors or ceilings on the amount of equalization aid to which a district is entitled or a range of tax rates over which equalization will apply.⁴³

D. *Fiscal Equalization at the State/Provincial Level*

While no one would suggest that the issues addressed in school finance litigation are simple, the fact is that these cases represent a relatively straightforward application of the fiscal disparities problem, at least as compared to the problem of remedying fiscal disparities among states or provinces. Whereas school finance equalization typically involves a single tax (i.e., the local property tax) and a single public good (i.e., public schools), the task of remedying fiscal disparities at the state

⁴² Following the DPE logic, districts with a tax base greater than the guaranteed tax base would be subject to a “negative aid” requirement. That is, they would be required to make a payment to the state government equal to the excess of the amount of revenue actually raised over the amount that would be raised by applying their chosen tax rate to the guaranteed tax base. Thus, again assuming a guaranteed tax base of \$50,000 per pupil, suppose that Rich District has a tax base of \$80,000 per pupil and applies a 4 percent tax rate. Without equalization, Rich District would raise \$3,200 per pupil. Under a conceptually pure DPE system, Rich District would be entitled to keep only \$2,000 per pupil and would be required to make a payment to the state in the amount of \$1,200 per pupil.

⁴³ For example, a state could choose to provide equalization payments up to a specific tax rate – say, 5 percent in the example from the text. Under that approach, a district would be guaranteed a tax base of \$50,000 per pupil only up to a tax effort of 5 percent, in effect capping the equalization payment at \$2,500 per pupil minus the amount that a 5 percent local tax effort would generate. For a discussion, see KERN ALEXANDER & RICHARD G. SALMON, *PUBLIC SCHOOL FINANCE* (1995) at 205 (noting that “Most states that have implemented guaranteed tax yield programs have established limitations on the amounts of local effort that may qualify for state equalization aid.”).

or provincial level is substantially more complicated. The complexity of the undertaking can be illustrated by reference to three distinguishing characteristics of the fiscal disparities problem at the state or provincial level.

The first is the *diversity of revenue sources* among state and provincial governments, as compared to the focus on a single tax in the school finance context. Within the United States, for example, many states rely on dozens of different taxes, fees and other mandatory charges, with the precise mix of revenue sources varying dramatically from state to state.⁴⁴ For example, consider the differences among the U.S. states in terms of their reliance on the individual income tax. Whereas individual income tax receipts account for as much as 20 percent of total state and local government revenues in states like Oregon and Massachusetts, a handful of states, including most prominently Florida and Texas, have chosen not to use an income tax at all.⁴⁵ There is equally significant variation in state and local sales tax receipts, with Washington collecting nearly a quarter of its state and local ownsource revenues from the retail sales tax, while Alaska collects merely 1.7 percent of its revenues from that levy. And again, a handful of states, such as Alaska, New Hampshire, and Oregon, have chosen not to impose a retail sales tax at all.⁴⁶

As a consequence of these differences in the basic tax structure of the states, the measurement of interstate fiscal disparities is significantly more complicated than it is when the sole focus is the local property tax. Whereas fiscal disparities in the school context are measured along a single metric—typically per pupil assessed valuation—determining state-level fiscal disparities requires an equalization methodology that is capable of reflecting the many different sources of taxable wealth upon

⁴⁴ Data on tax collections by state and local governments by type of tax are compiled by the Census Bureau and available in the Census of Government publications. See, e.g., U.S. Census Bureau, Census of Governments, State and Local Government Finances: 2005-06, *Table 1. State and Local Government Finances by Level of Government and by State: 2005-06* (available at <http://ftp2.census.gov/govs/estimate/06slsstab1a.xls>).

⁴⁵ David L. Sjoquist, *Revenue Structures of States Without An Income Tax*, STATE TAX NOTES 889 (June 18, 2007).

⁴⁶ John L. Mikesell, *State Sales Taxes in Fiscal 2007: More Slow Growth*, STATE TAX NOTES 647, 650 (May 26, 2008) (listing Alaska, Delaware, Montana, New Hampshire, and Oregon as states without sales taxes).

which the states rely. At stake is the reliability of the equalization system to properly identify which states are “rich” and which are “poor.” An approach that takes a narrow view of state fiscal capacity runs the risk of identifying as “poor” states that in fact have access to significant taxable resources. On the other hand, an overly broad view of fiscal capacity may include as taxable wealth certain sources of revenue that are not realistically available for the state to tax.

A second differentiating feature of state/provincial fiscal disparities concerns the *scope of expenditure responsibilities* of beneficiary governments. School finance equalization is of course focused on school districts, which have public schools as their sole responsibility. By contrast, state and provincial governments have a much broader range of expenditure responsibilities, including education, welfare, prisons, police and fire protection, etc.... Moreover, within most federations there is great variation in the government services offered by state and provincial governments. Traditionally, the object of fiscal equalization policies has not been to equalize spending among states or provinces with respect to a particular program or programs. Rather, as captured by Section 36 of Canadian Constitution, the aim is “to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”⁴⁷ This language suggests a more agnostic outlook regarding the tax and spending priorities of state and provincial governments. Consistent with that outlook, equalization grants, both as urged by commentators and as observed in practice, are typically designed with “no strings attached.” Indeed, strict adherence to the unconditional nature of equalization payments would allow beneficiary governments to use the payments even for local tax relief, further distinguishing state/provincial equalization from the school finance context, where local tax effort is often (e.g., the DPE methodology) explicitly incorporated into state aid formulas.⁴⁸

⁴⁷ Part III, *Equalization and Regional Disparities*, Section 36, The Constitution Act, 1982.

⁴⁸ The question of the appropriate role of “tax effort” in a state/provincial equalization program has received only cursory academic attention. See, e.g., Enid Slack, *Territorial Formula Financing: Prepared for the Expert Panel on Equalization and Territorial Formula Financing* 8-10 (August 8, 2005) (discussing the role of “fiscal effort” in equalization regimes and noting that “inclusion of fiscal effort in the formula

Finally, consider the question of how differences in fiscal capacity may influence property values. Recall that in California, pre-*Serrano*, Baldwin Park imposed a tax rate of more than twice the rate used in Beverly Hills, yet it raised less than half the amount of revenue. One might expect such a dramatic difference in fiscal capacity among local governments to influence housing prices in the two jurisdictions. More specifically, one would expect otherwise comparable properties to sell for a premium in Beverly Hills and a discount in Baldwin Park. This possibility substantially complicates the argument in support of equalization, at least insofar as property owners in Beverly Hills have already “paid for” the fiscal advantages they enjoy.⁴⁹ The waters are further muddied by the possibility that equalization policies may themselves be capitalized into property values, increasing housing prices (and rents) in low capacity jurisdictions and reducing them in high capacity jurisdictions.⁵⁰ The policy implications of these dynamics are not obvious, but it is clear enough that capitalization of interjurisdictional fiscal disparities is a complicating feature of equalization grants at the local level.

Is there a similar dynamic at work at the state level? From a conceptual perspective, there is no reason to distinguish between the capitalization effects at the two different levels of governments. One would expect fiscal differentials to be reflected in property values regardless of whether the geographic regions under consideration are state governments or local governments. If so, the equity case for fiscal equalization grants is weaker since “residents of rich states pay more for private services and less for public services and vice versa in poorer

compromises the unconditional nature of equalization grants”); Jorge Martinez-Vasquez and Jameson Boex, *Fiscal Capacity: An Overview of Concepts and Measurement Issues and Their Applicability to the Russian Federation*, Working Paper 97-3, Andrew Young School of Policy Studies, Georgia State University (1997) (arguing that there is little justification for equalization grants to increase with local fiscal effort).

⁴⁹ As Hamilton put the argument in an early article, “If differential fiscal surpluses are capitalized into demand curves for property, there can be no horizontal inequity in a static world.” (Hamilton, *Capitalization of Intra-jurisdictional Differences in Local Tax Prices*, 66 AMERICAN ECONOMIC REVIEW 743 (1976).

⁵⁰ For a discussion of these issues, see Paul Gary Wyckoff, *Capitalization, Equalization, and Intergovernmental Aid*, 23 PUBLIC FINANCE REVIEW 484 (1995).

states.”⁵¹ To date, however, empirical studies have only shown capitalization effects at the local level.⁵² For example, on the question of whether school quality is capitalized into property values, we do have some indication that housing price differentials are more likely to be observed among localities than among states. As Fischel notes, “in contrast to the large number of economic studies that find capitalization of local school quality measures, there are no studies that find interstate capitalization of school spending or test scores.”⁵³ Whereas individuals making residential choices within a metropolitan area are likely to be choosing among numerous local governments, with fiscal advantages and disadvantages embedded within property values, these market effects have less obvious effects among states.⁵⁴ Thus, while theory would predict capitalization of interstate NFB differentials, existing evidence suggests that property values may be more responsive to inter-local variation than to differences among the states.

E. *Fiscal Equalization in Practice: Canada and Australia*

As noted above, equalization grants are a commonplace institution among federations throughout the world. Dozens of countries in Asia, Africa, Europe and the Americas have adopted equalization policies as a means of reducing disparities in taxable resources available to state and local governments. While the details vary from country to country, the basic structure of any given nation’s equalization regime is typically a function of certain core decisions, including issues such as the range of revenue instruments subject to equalization, whether the grant formula incorporates a measure of expenditure need, whether local tax effort influences a donee state’s equalization payment, whether donor states must contribute to an equalization pool (or, alternatively, payments are

⁵¹ Anwar Shah, *A Practitioner’s Guide to Intergovernmental Fiscal Relations*, in INTERGOVERNMENTAL FISCAL TRANSFERS: PRINCIPLES AND PRACTICE 20 (World Bank 2007)

⁵² See Anwar Shah, *A Practitioner’s Guide to Intergovernmental Fiscal Transfers*, 1, 20 (noting that “full capitalization requires a small open area with costless mobility” and that, as a result “criticism of fiscal equalization using the capitalization argument may have only weak empirical support”) (published in Boadway/Shah volume, *supra* note 2).

⁵³ William A. Fischel, *The Local Property Tax: An Efficient Method of Funding High-Quality Public Education in New Hampshire* (November 1995).

⁵⁴ Wyckoff, *supra* note 50 at 505 (noting that capitalization effects are less likely in situations where “voting with the feet” is impractical, such as a rural setting).

financed from federal taxes), whether natural resource revenues are to be equalized, etc... In an effort to offer some perspective on how these decisions have been resolved in practice, this portion of the article offers a basic overview of how equalization works in two federations with a long tradition of equalization grants—Canada and Australia. As explained below, despite the many similarities between these two countries, their equalization regimes exhibit quite different features.

1. *Canadian Equalization*

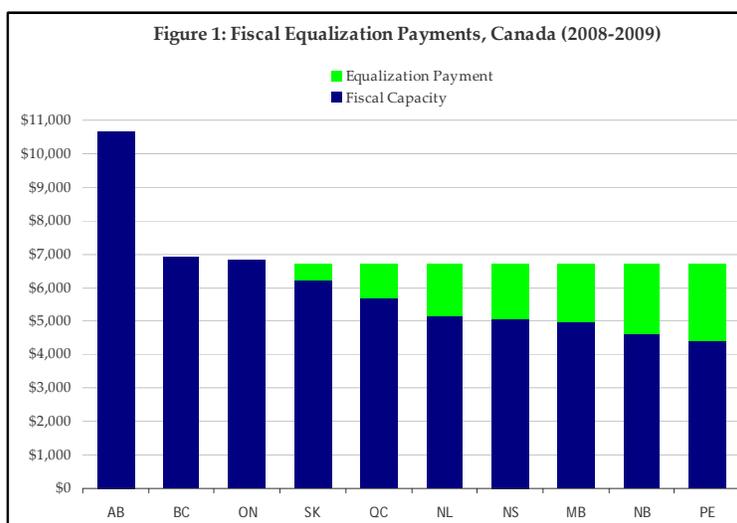
Canada has had a system of equalization grants in place since 1957, though significant changes took effect in 1982 with the adoption of section 36 of the Canadian Constitution. As noted above, section 36 envisions federal equalization policies designed “...to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public service at reasonably comparable levels of taxation.”⁵⁵ Since 1967, Canada has followed a “representative tax system” approach in determining the amount of equalization payments to which a province is entitled. Under the RTS methodology, the amount of equalization aid that a province receives is determined by reference to (i) that province’s own-source per capita revenue capacity, and (ii) a standard level of per capita revenue capacity. Prior to 2007, the standard figure was based on the revenue capacity of Canada’s five “middle-rich” provinces—British Columbia, Saskatchewan, Manitoba, Ontario, and Quebec. With the introduction of several important reforms in 2007, however, Canada has now shifted to a full ten province standard so that the revenue capacity of every province is taken into account for purposes of determining each province’s equalization payment for the year.⁵⁶

The amount of equalization aid to which a province is entitled varies from year to year. For the 2008-2009 fiscal year, the standard per capita

⁵⁵ Part III, *Equalization and Regional Disparities*, Section 36, The Constitution Act, 1982.

⁵⁶ The 2007 changes were adopted at the recommendation of an expert panel on the Canadian equalization program, which released its report in 2006. See EXPERT PANEL ON EQUALIZATION AND TERRITORIAL FORMULA FINANCING, *ACHIEVING A NATIONAL PURPOSE: PUTTING EQUALIZATION BACK ON TRACK* (May 2006).

revenue capacity is approximately \$6,730.⁵⁷ Of Canada’s ten provinces, seven are expected to be “receiving provinces” for 2008-2009 (including Manitoba, New Brunswick, Newfoundland, Nova Scotia, Prince Edward Island, Quebec and Saskatchewan) and three are expected to be “non-receiving” provinces (Alberta, British Columbia, and Ontario).⁵⁸ The chart below shows two figures for each of the ten provinces. The blue bar represents the province’s fiscal capacity, ranging from a high of \$10,673 for Alberta to a low of \$4,398 for Prince Edward Island. The green bar shows the per capita equalization payment that each province will be entitled to receive.⁵⁹ Payments range from \$525 per capita for Saskatchewan to \$2,332 for Prince Edward Island. In absolute dollar figures, the largest beneficiary of the Canadian equalization program is by far Quebec, which will receive approximately 59 percent of all provincial equalization payments for 2008-2009.⁶⁰



⁵⁷ TABLE 1, CALCULATION OF EQUALIZATION PAYMENTS FOR 2008-2009, 50% RESOURCE REVENUE INCLUSION (December 21, 2007) (Excel spreadsheet on file with author).

⁵⁸ Under alternative scenarios not discussed here it is possible that Saskatchewan will not receive any equalization payments, as compared to the \$525 per capita figure noted in the text.

⁵⁹ The amount of the equalization payment is the \$6,730 standard figure minus the province’s fiscal capacity.

⁶⁰ Note that actual percentage received by any province depends on the precise amounts included in the denominator. The figure in the text excludes so-called “Accord Offsets.”

Over the past quarter century, the overall budgetary cost of the Canadian equalization program has ranged from just under .75 percent to just over 1.25 percent of GDP. In terms of the significance of the program to the federal budget, the equalization program has accounted for between 5 and 7 percent of total federal expenditures over the past 25 years.⁶¹ For 2008-09, the federal government is expected to make payments totaling approximately \$13.6 billion.⁶²

Several features of the Canadian equalization system deserve further elaboration because of their relevance to the design of a possible equalization program in the United States.

Defining “Fiscal Capacity.” It bears noting that the term “fiscal capacity” as used in the Canadian equalization program does not refer to the maximum amount of taxable resources available to a province. Such an approach would obviously require a centralized judgment to be made regarding which economic resources are available for taxation (i.e., a tax base) and what level of tax burden owners of those resources should be asked to bear (i.e., a tax rate). To some degree, these choices are inescapable in the design of an equalization regime; however, alternative equalization regimes involve varying levels of normative judgments regarding the determination of fiscal capacity. Along the spectrum of alternative regimes, Canada has chosen an approach—the “representative tax system” methodology—that attempts to minimize the influence of centralized political judgments regarding which provincial resources are and are not available for taxation. This approach takes an agnostic view regarding alternative measures of fiscal capacity and relies on the actual practices of the provinces to determine which are “rich” and which are “poor.” More precisely, each province’s fiscal capacity is determined by multiplying its tax base (actually a combination of 33 different tax bases) by an average tax rate for each tax.⁶³ This process produces a hypothetical amount of revenue that could be raised *if the province were to impose average tax rates on a standard set of tax bases*. That figure is

⁶¹ Canadian Equalization Report (May 2006), p. 28-29.

⁶² See Canada Department of Finance, *Equalization Program* (available on the Canadian Department website at <http://www.fin.gc.ca/FEDPROV/eqpe.html>) (last visited on August 14, 2008).

⁶³ By contrast, when equalization was first adopted in Canada in 1957, only three revenue sources were used to calculate equalization payments.

then compared to the standard figure to determine the base level of equalization aid to which the province is entitled.

The Meaning of “Equalization.” It should also be noted that Canada’s “equalization” system does not result in a true equalization of provincial revenues or expenditures. Provinces with a per capita fiscal capacity less than the nationwide average fiscal capacity (e.g., Prince Edward Island) are “leveled up” to that average; however, provinces with a per capita fiscal capacity above the average (e.g., Alberta) are not “leveled down.” Because of this feature, it is sometimes noted that the Canadian system is a “gross” or “paternal” system in which “transfers are made to provinces with positive entitlements, but negative entitlements are not extracted from the others.”⁶⁴ By contrast, Germany follows a “net” or “fraternal” system whereby equalization payments are funded explicitly by payments from the wealthier “donor” *Länder*.⁶⁵ Another way of describing the Canadian system is to note that it is not “self-financing.” That is, payments to the receiving provinces are financed out of general federal revenues (which in Canada consist primarily of receipts from the personal and corporate income taxes, as well as the federal goods and services tax). While one would expect a substantial share of Canada’s federal taxes to come from individuals and businesses located in wealthier provinces, like Alberta and Ontario, it bears emphasizing that this is not a logical or necessary result of the design of the equalization regime.

The Role of Tax Effort. Under the Canadian equalization system, a province’s own tax effort does not influence the equalization payment to which it is entitled, except insofar as that tax effort enters into the national average tax rate. Recall that under the “district power equalizing” approach advanced by Professors Coons, Clune and Sugarman in the U.S. school finance context the amount of state aid to which a district was entitled was (in part) a function of the property tax rate the district was willing to impose on itself. Thus, assuming a guaranteed tax base of \$50,000 per pupil, a district with an actual tax base of \$40,000 per pupil would be able to increase its state aid by \$100

⁶⁴ Robin Boadway, *Evaluating the Equalization Program: Notes for the Expert Panel on Equalization and Territorial Formula Financing*, 8-10 (2005). See Ronald L. Watts & Paul Hobson, *Fiscal Federalism in Germany* 37 (December 2000).

⁶⁵ See Ronald L. Watts & Paul Hobson, *Fiscal Federalism in Germany* 37 (December 2000).

per pupil increasing its tax rate from 2 percent to 3 percent. That is, the amount of equalization payment a school district is entitled to receive under a pure DPE approach would increase with a lower local tax base and higher local tax effort. By contrast, the Canadian RTS methodology disregards provincial tax effort in calculating equalization payments, in effect assuming that provinces are imposing average tax rates.

Some may view the lack of adjustment for provincial tax effort as inappropriate. An equalization regime that incorporates tax effort might be thought desirable on the grounds that federal resources should not be expended on behalf of a province unless and until there is sufficient local political will to tap local economic resources. This sort of thinking seems to underlie matching grants, the most common type of intergovernmental transfers in the United States. If the objective is to stimulate subnational spending in a particular program area, then a matching formula is clearly appropriate. As noted in Section B above, however, the principal objective of equalization is not to influence subnational spending levels but rather the reduction of net fiscal benefit differentials between otherwise similarly situated individuals residing in states with disparate fiscal capacity. Linking grant levels to tax effort would mark a departure from equalization's commitment to unconditional transfers, in effect putting a thumb on the scale in favor of increasing provincial tax burdens.⁶⁶ Moreover, to the extent that provincial expenditure programs can be adjusted in such a manner to compensate local taxpayers for increased tax burdens, including tax effort in the equalization formula could encourage provincial strategies to maximize the inflow of federal dollars. This has been an ongoing problem in the context of the U.S. Medicaid system, where an elaborate set of regulations has emerged to prevent such games.⁶⁷

Regional Cost of Living Differences. Finally, it is worth noting that the Canadian system of equalization takes no account of regional cost-of-living differences. As in many large and diverse countries, the cost of

⁶⁶ Anwar Shah, *A Practitioner's Guide to Intergovernmental Fiscal Transfers* 33, in *INTERGOVERNMENTAL FISCAL TRANSFERS: PRINCIPLES AND PRACTICE* (edited by Robin Boadway & Anwar Shah) (2006).

⁶⁷ Katherine Baicker, *Fiscal Shenanigans, Targeted Federal Health Care Funds, and Patient Mortality*, 120 *QUARTERLY JOURNAL OF ECONOMICS* 345 (2005); Teresa Coughlin, Leighton Ku, Johnny Kim, *Reforming the Medicaid Disproportionate Share Hospital Program*, 22 *HEALTH CARE FINANCING REVIEW* (2000).

living in Canada varies from province to province and even among cities within a single province. Because it relies on nominal revenue capacity figures rather than real, cost-adjusted amounts, the Canadian equalization system arguably “overcompensates” certain beneficiary jurisdictions, at least to the extent that provincial tax capacity correlates with regional price levels, which seems likely. As one critic noted, “The cost of living on the West Coast and central Ontario is 25% higher than it is in Montreal or Saint John, so why should the equalization scheme treat each dollar it transfers as though it bought the same level of services in each jurisdiction?”⁶⁸

The implications of regional cost-of-living differences for a federation’s equalization policy have not been adequately explored in the academic literature on fiscal equalization. On the one hand, it would seem appropriate to adjust equalization grants based on the relative cost of inputs for government services. If a “have-not” province can offer a standard bundle of public services for substantially less than a “have” province, equalizing on the basis of nominal revenue capacity would seem to misdirect federal equalization dollars. On the other hand, to the extent that regional cost differentials reflect differential amenities (perhaps even differential public sector amenities, which themselves may be a product of fiscal disparities), the case for adjusting grant levels for those cost differences is less clear.⁶⁹ Thus, the theoretical case for adjusting equalization grants for regional cost differences is ambiguous. This issue will be discussed further below in connection with the empirical simulations using U.S. fiscal disparities data.

⁶⁸ Lorne Gunter, *Some Are More Equal Than Others*, NATIONAL POST (June 6, 2006).

⁶⁹ Louis Kaplow, *Regional Cost-of-Living Adjustments in Tax/Transfer Schemes*, 51 TAX L. REV. 189-193 (1996). For example, let us assume that the cost of living in one jurisdiction is higher because of certain government-provided amenities, such as education. Should such a jurisdiction receive a larger equalization payment due to its higher cost of living? The answer would seem to be no. Indeed, directing larger equalization payments to those jurisdictions with a higher cost of living that is attributable to government-provided amenities would seem to reward those jurisdictions that are best positioned to offer such amenities (i.e., jurisdictions with greater fiscal capacity), thus defeating the purpose of the equalization program. *See also* Michael S. Knoll and Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV. L. REV. 987 (2003).

2. Australian Equalization

Nearly all commentary on Australian fiscal federalism begins with some remark regarding the degree of vertical fiscal imbalance apparent in the country's federal fiscal arrangements. The term "vertical fiscal imbalance" refers to the mismatch between the level of government empowered to raise revenue and the level of government charged with expenditure responsibilities.⁷⁰ In Australia, expenditure responsibilities are divided between the federal and state governments in approximately the same manner as in the United States. The federal government has responsibility for national security, international trade, foreign affairs, etc..., while the state governments are charged with areas such as education, police and fire protection, and health care. Significantly, however, nearly all taxing authority is vested in the federal Commonwealth as a result of a series of important High Court rulings regarding the taxing authority of the Australian states. As a result, the states rely heavily on intergovernmental transfers to meet their expenditure obligations. Under longstanding practice, the Commonwealth has followed equalization principles in the determination of grant payments to the states.⁷¹

The details of the Australian equalization program differ from those of the Canadian system in several respects. Unlike in Canada, there is no express constitutional authority for an equalization regime in Australia. Instead, section 96 of the Australian constitution simply provides that "the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit."⁷² Perhaps the most striking feature of the Australian approach is the incorporation of a measure of *expenditure need* as a factor in determining a state's equalization grant.⁷³

⁷⁰ Department of the Parliamentary Library, *Public Finance and Vertical Fiscal Imbalance*, Research Note 2002-03 (October 2002); see also Robin Boadway and Jean-Francois Tremblay, *A Theory of Vertical Fiscal Imbalance*, IFIR WORKING PAPER NO. 2006-04 (April 2005) (available at http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2006-04.pdf).

⁷¹ Alan Morris, *Australia: Equity, Imbalance, and Egalitarianism*, in *DIALOGUES ON THE PRACTICE OF FISCAL FEDERALISM: COMPARATIVE PERSPECTIVES*, 3-5 (2006) (edited by Raoul Blindenbacher and Abigail Ostien Karos).

⁷² SECTION 96, CHAPTER IV (FINANCE AND TRADE), CONSTITUTION OF AUSTRALIA.

⁷³ Australia consists of six states (New South Wales, Queensland, South Australia, Tasmania, Victoria, and Western Australia) and two mainland territories (Australian Capital Territory and Northern Territory). The Commonwealth of Australia was

The Australian equalization program also differs in its reliance on the “Commonwealth Grants Commission,” an independent federal agency, to work out the details of each year’s equalization transfers. Established in 1933, the Australian CGC seeks to implement fiscal equalization policies in accordance with a principle similar to basic idea articulated in Article 36 of the Canadian Constitution: “each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources.”⁷⁴

II. FISCAL DISPARITIES & EQUALIZATION: THE U.S. EXPERIENCE

As noted in the introduction, the U.S. stands alone among the world’s major federations in not having adopted a federal equalization policy to address subnational fiscal disparities.⁷⁵ Should the U.S. adopt such a policy? Before considering this question, two threshold matters must be addressed. First, the case for an equalization program requires a showing that there are indeed interstate fiscal disparities that an equalization program would address. That is, is it in fact the case that the U.S. states differ in their fiscal capacity? If so, what are the magnitudes? Second, could it be that the U.S. already equalizes states’ taxing capacities under some other name? Perhaps existing federal policies have the effect of equalizing fiscal capacity among the states, even if they are not expressly labeled as “fiscal equalization.” If this is the case, then it would hardly seem necessary to supplement existing policies with an additional equalization program.

This Part addresses these two questions. Subsection A below reviews the most recent data concerning fiscal disparities among the U.S. states, demonstrating the variation in tax and revenue capacity as of 2005. Subsection B then considers whether existing federal grant programs have the effect of reducing these disparities. It is shown that, despite the

founded in 1901 with the independence of the six former colonies from British rule and the adoption of the nation’s constitution.

⁷⁴ Commonwealth Grants Commission, *The Commission and its History* (2002).

⁷⁵ See Keen, *supra* note 1 at 779 (describing equalization policies of several countries and concluding that the “United States stands alone among the federations of the advanced economies in its failure to equalize across the states.”). See also Richard M. Bird and Michael Smart, *Intergovernmental Fiscal Transfers: Some Lessons from International Experience* 5, n.6 (2001) (describing U.S. as “the only developed federal country with no general federal equalization system.”).

inclusion of per capita income in various grant formulas, federal grants do not generally direct greater resources to states with lower fiscal capacity. In fact, there appears to be virtually no relationship between per capita federal grants and per capita fiscal capacity. Finally, in an effort to understand why federal grants do not have an equalizing effect, subsection C focuses on the design of the Medicaid program, which, at an annual cost to the federal government of roughly \$170 billion (2005) is the largest program of federal intergovernmental assistance in the United States.

A. *Data on Fiscal Disparities among the U.S. States*

1. *Alternative Measures of Fiscal Capacity*

Documenting the extent of interstate fiscal disparities first requires one to specify the methodology for measuring those disparities. Unfortunately, there is no single methodology upon which all commentators and policymakers will agree. Historically, the most common approach was simply to use state-level *per capita income* data, which are readily available and relatively easy to understand. However, for a variety of reasons per capita income is an inadequate measure of fiscal capacity. For example, per capita income figures fail to account for the extent to which a state can export tax burdens to nonresidents.⁷⁶ In states such as Nevada or Hawaii, which rely heavily on non-resident tourism as a source of state revenue, per capita income significantly understates fiscal capacity. For these and other reasons, most commentators working in this area have rejected per capita income as an appropriate measure of fiscal capacity.

An alternative approach attempts to gauge the extent of economic activity within a state. Since 1992, the U.S. Treasury Department has calculated the *total taxable resources* (TTR) available to each of the 50 states and the District of Columbia. The TTR figure for any given state is calculated by reference to the state's Gross State Product, modified upward and downward to take account a several specific amounts (e.g., increased for dividend income received by state residents, decreased for

⁷⁶ H. CLYDE REEVES, *MEASURING FISCAL CAPACITY* 3 (1986) (noting that the per capita income measure is often criticized because "it ignores tax exportation between the states.").

Social Security contributions).⁷⁷ One advantage of the TTR methodology is that the GSP figure represents a relatively broad measure of the economic resources available to a state. In addition, like per capita income, these data are readily available and easy to understand. The TTR figures are currently used in the formula for allocating federal block grants for the Community Mental Health Services program and the Substance Abuse Prevention and Treatment program.

A third approach is the *representative tax system* (RTS) methodology used in the Canadian equalization program. The RTS approach determines relative tax capacity by specifying a hypothetical tax system based on the most commonly used taxes and average tax rates. It then estimates the per capita tax yield that adopting such a system would produce in each state. More precisely, the RTS methodology involves (1) determining a standardized “representative” tax base for each of the taxes most commonly used by the 50 states (the *representative tax base*), (2) determining the average tax rates used by the states for each of those taxes (the *nationwide average tax rate*), (3) applying the nationwide average tax rate for each tax to each state’s allocable share of the representative tax base for each tax to determine each state’s “tax capacity” for each tax, (4) for each state, adding together the revenue potential of all the taxes (the *total tax capacity*), (5) dividing the total tax capacity by the state’s population (the *per capita tax capacity*). By this method, each state can be assigned a per capita tax revenue capacity that, while a theoretical construct, is based on taxes actually in use in the 50 states.⁷⁸

Because of significant differences in the structure of state tax systems, the specification of the hypothetical base is critical in determining the details of a fiscal equalization program. For example, consider Florida, where the state constitution prohibits an individual income tax. Under the RTS methodology, Florida’s tax capacity is determined in part by

⁷⁷ Treasury Department, *Treasury Methodology for Estimating Total Taxable Resources* (November 2002) (at <http://www.treas.gov/offices/economic-policy/resources>).

⁷⁸ From these figures a nationwide average can be determined and indexed to 100. Thus, the degree to which any given state’s indexed fiscal capacity falls short of (exceeds) 100 reveals the extent to which that state’s capacity deviates from the nationwide average. Rankings of the 50 states based on 2002 data are set forth in an appendix. These data are reproduced from Tannenwald/Turner, *Interstate Fiscal Disparities* (April 2006).

reference to its ability to impose a personal income tax. It seems likely that Florida would oppose any equalization methodology that assumes that it could impose a constitutionally prohibited tax. A similar issue arises in the case of California, whose constitution requires property taxes to be determined by reference to the property's acquisition value, rather than its current fair market value. Yet under the RTS methodology, California's property tax capacity is determined by reference to the fair market value of the property.⁷⁹ As these examples suggests, the details of whatever methodology is chosen will likely be a source of political controversy.

Finally, fiscal capacity might be defined to include not just taxes but various other sources of revenue, such as user fees, lotteries, rents and royalties. This broader measure, known as the *Representative Revenue System* (RRS) methodology, has the advantage of more fully capturing the diverse sources of revenue used to finance state and local government activities. On the other hand, the RRS approach can sometimes involve difficult line-drawing questions, and further complicates the already complex RTS methodology. In addition, at a conceptual level, it is not clear whether (or how) an equalization program should attempt to equalize things such as lottery revenues, hospital charges or college tuition. "Equalizing" these revenue sources requires specifying a revenue base (such as personal income, for example) so that a nationwide "user charge rate" can be determined and then applied to each state's revenue base.⁸⁰ As a result, including user charges in the equalization formula augments the formula's equalizing effect with regard to interstate differences in the specified revenue base.

⁷⁹ The California property tax raises another complication of the RTS methodology, which is how data are to be acquired for the fair market value of property when such data are not collected or used in connection with the actual use of the property tax. There are ways to estimate the value of real property in the state, but it is important to recognize the limitations of the methodology of arriving at these estimates.

⁸⁰ In calculating "user charge capacity," the Tannenwald study uses personal income as the revenue base. Determining the states' user fee "capacity" involves (1) calculating a nationwide average user charge rate (i.e., the total amount of user charges collected by all 50 states, divided by nationwide personal income), and (2) multiplying that user charge rate by each state's personal income. As a result, each state's "user charge capacity" is essentially a function of its personal income.

2. Fiscal Capacity Data for the U.S. States: 2005

Beginning in the early 1960s, the U.S. Advisory Commission on Intergovernmental Relations (ACIR) periodically published fiscal capacity data for the 50 states.⁸¹ Since 1995, when Congress terminated the ACIR,⁸² economist Robert Tannenwald of the Boston Federal Reserve has continued to publish fiscal capacity data using the RTS and RRS methodologies. In late 2006, Tannenwald and a group of economists released a study of fiscal disparities among the states with the Tax Policy Center and the Urban Institute.⁸³ These data were recently updated by Yilmaz and Zahradnik.⁸⁴ My principal focus will be the data relating to the “tax capacity” and “revenue capacity” of the 50 states. Each state’s “tax capacity” is based on a bundle of 20 separate taxes actually used in the states. These taxes are listed in Table 1 below.

TABLE 1: REPRESENTATIVE TAX SYSTEM (RTS) COMPONENTS			
U.S. AVERAGE PER CAPITA TAX CAPACITY			
U.S. Average Per Capita Tax Capacity: \$3,726			
	<i>U.S. Average</i>		<i>U.S. Average</i>
1. Retail Sales Tax	\$887	11. Motor Vehicle Registration	\$ 66
2. Motor Fuels Tax	\$121	12. Motor Vehicle Operators	\$ 7
3. Public Utilities Tax	\$ 76	13. Corporation Licenses	\$ 25
4. Insurance Sales Tax	\$ 50	14. Fishing and Hunting	\$ 4
5. Tobacco Tax	\$ 45	15. Personal Income Tax	\$813
6. Spirit Sales Tax	\$ 19	16. Corporate Income Tax	\$145
7. Wine Sales Tax	\$ 6	17. Property Tax	\$1,132
8. Beer Sales Tax	\$ 21	18. Estate and Gift Tax	\$ 18
9. Amusement Tax	\$ 19	19. Severance Tax	\$ 28
10. Pari-Mutuels Tax	\$ 1	20. All Other Taxes	\$243

Source: Yilmaz & Zahradnik (2008)

Note that for 2005 the U.S. average per capita tax capacity (representing the combined average tax capacity for all 20 taxes) is

⁸¹ These data were reported in an annual ACIR report. *See, e.g.,* ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, 1981 TAX CAPACITY OF THE FIFTY STATES (1983).

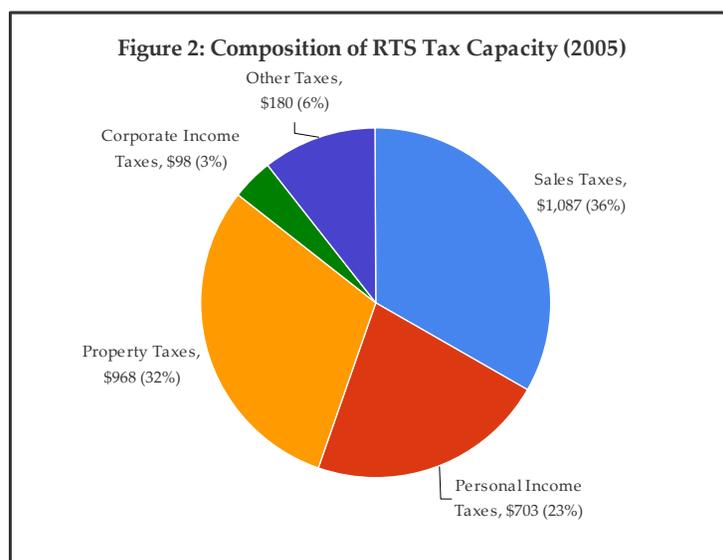
⁸² P.L. 104-52 (1995).

⁸³ Yesim Yilmaz, Sonya Hoo, Matthew Nagowski, Kim Rueben, Robert Tannenwald, *Measuring Fiscal Disparities across the U.S. States: A Representative Revenue System/Representative Expenditure System Approach, Fiscal Year 2002* (November 2006) (referred to throughout as the “Tannenwald Study.”)

⁸⁴ Yesim Yilmaz and Robert Zahradnik, *Measuring the Fiscal Capacity of the District of Columbia, Fiscal Year 2005* (November 2008) (manuscript on file with author) (referred to throughout as the Yilmaz/Zahradnik Study).

\$3,726. This figure represents *actual* per capita state and local tax collections for the entire country for 2005. Thus, we can say that, on average, Americans paid \$3,726 in state and local taxes for that year.

Of the \$3,726 amount, 79 percent is accounted for by three taxes: the retail sales tax (\$887 per capita, or 24 percent), the personal income tax (\$813 per capita, or 23 percent) and the property tax (\$1,132 per capita, or 32 percent). By including various “selective sales taxes” (items 2 through 10 in Table 1) in the sales tax category, the sales tax percentage increases to 36 percent, which along with income and property taxes would then account for a total of 91 percent of the RTS tax base, as shown in Figure 2 below. Understanding these magnitudes will help to put “tax capacity” disparities into perspective. As discussed in further detail below, RTS differentials among the states are fundamentally a function of variation in the tax base for the “Big 3” state/local taxes—i.e., retail sales taxes, personal income taxes, and property taxes.



Of course, focusing on national averages obscures the extent of variation among the states. For example, while Connecticut has a per capita tax capacity of \$4,910, Mississippi’s tax capacity is 53 percent of that amount at \$2,607 per capita.⁸⁵ Figure 3 below illustrates the extent

⁸⁵ See Tannenwald Study, *supra* note 83.

of variation in RTS per capita tax capacity among the states. These figures are based on applying the average nationwide tax rate to the state’s allocable share of each of the 20 taxes listed in Table 1. Thus, each state’s tax capacity derives from a unique combination of tax specific capacity figures. For example, Massachusetts has a property tax capacity of \$1,932 (38 percent of its total tax capacity) while Alaska has a severance tax capacity of \$1,397 (26 percent of its total tax capacity).⁸⁶ The figures shown next to each state represent the sum total of that state’s tax capacity for all 20 taxes.

INSERT FIGURE 3 HERE

To understand the sources of the fiscal disparities shown in Figure 3, we can disaggregate the RTS figure into its various components. Not surprisingly, fiscal disparities among the U.S. states are chiefly a function of differences in the personal income tax, the property tax, and the retail sales tax. Table 2 below shows the top five and bottom five states with regard to each of these three taxes.

Table 2: Per Capita Tax Capacity for “Big 3” Sources of State/Local Government Revenue (2005)	
<i>Per Capita Personal Income Tax Capacity (U.S. average: \$813)</i>	
<i>Top 5</i>	<i>Bottom 5</i>
1. Connecticut (\$1,234)	46. New Mexico (\$591)
2. Massachusetts (\$1,124)	47. Louisiana (\$571)
3. Maryland (\$1,030)	48. Arkansas (\$567)
4. New York (\$1,029)	49. West Virginia (\$527)
5. Delaware (\$1,010)	50. Mississippi (\$474)
<i>Per Capita Property Tax Capacity (U.S. average: \$1,132)</i>	
<i>Top 5</i>	<i>Bottom 5</i>
1. Massachusetts (\$1,932)	46. Oklahoma (\$753)
2. California (\$1,665)	47. Arkansas (\$723)
3. New Hampshire (\$1,594)	48. Louisiana (\$674)
4. Connecticut (\$1,561)	49. West Virginia (\$668)
5. Hawaii (\$1,531)	50. Mississippi (\$633)
<i>Per Capita Sales Tax Capacity: (U.S. average: \$887)</i>	
<i>Top 5</i>	<i>Bottom 5</i>
1. Nevada (\$1,566)	46. Alabama (\$771)
2. New Hampshire (\$1,275)	47. West Virginia (\$771)
3. Hawaii (\$1,211)	48. Idaho (\$759)
4. Delaware (\$1,087)	49. Mississippi (\$735)
5. Florida (\$1,052)	50. Oklahoma (\$722)
<i>Source: Yilmaz & Zahradnik (2008)</i>	

⁸⁶ See Yilmaz/Zahradnik Study, *supra* note 84.

It bears noting that actual tax receipts need not bear any relationship to a state's tax capacity so defined. In some cases, states may "undertax" a particular tax base (relative to the national average), while in other cases states may "overtax" a particular tax base. For example, under the RTS methodology California had a per capita property tax capacity of \$1,665 for 2005, while its actual per capita property tax receipts for the year totaled only \$942.⁸⁷ The difference between these two numbers is chiefly a function of Proposition 13, the famed constitutional amendment limiting the property tax in California.⁸⁸ Even more dramatic are the differences between Florida's per capita income tax capacity (\$686) and its actual income tax receipts (\$0) or Oregon's per capita sales tax capacity (\$787) and its actual sales tax receipts (\$0).⁸⁹

In other cases, a state's actual tax receipts may far outstrip its capacity, such as in the case of Maryland, which has a per capita income tax capacity of \$1,030 yet has actual income tax collections of \$1,638 per capita.⁹⁰ Here the explanation seems to lie in the structure of the state's income tax. The state not only has a robust system of local income taxes (at a rate of 1.25 percent), but the top bracket of the state personal income tax kicks in at a mere \$3,000, with the result that virtually all residents have most of their income taxed at top marginal rate.⁹¹ In addition, because of reciprocal tax arrangements, Maryland taxes the income earned by its residents in certain other jurisdictions (Pennsylvania, DC, Virginia, and West Virginia), whereas most states (e.g., Connecticut) tax the income of their residents earned in other states but allow a credit for income taxes paid to those other jurisdictions.

B. *Are Current U.S. Federal Grants Equalizing?*

The preceding section has reviewed the most recent data showing the existence of fiscal disparities among the states. Before considering the design and effect of an equalization policy for the United States, it is appropriate to consider whether existing policies already have the effect of mitigating these disparities. That is, do existing federal grant

⁸⁷ Yilmaz & Zahradnik (November 2008).

⁸⁸ California Constitution, Article XIII.

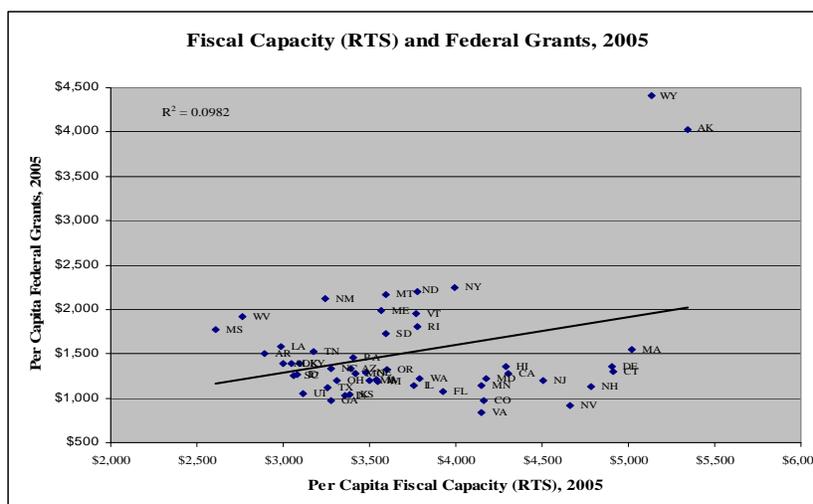
⁸⁹ Yilmaz & Zahradnik (November 2008).

⁹⁰ Id.

⁹¹ DEPARTMENT OF LEGISLATIVE SERVICE, OFFICE OF POLICY ANALYSIS, *Overview of Maryland's Tax Structure* (2002) (available at <http://mlis.state.md.us>).

programs favor states with lower fiscal capacity? And, if so, to what degree?

As a first cut in answering these questions, consider the relationship between current per capita federal grants and state fiscal capacity as measured by the representative tax system approach. The scatterplot below reveals almost no relationship between a state's 2005 RTS tax capacity and the per capita amount that the state received in federal assistance for that year. Note that there is a slight positive correlation between the two variables, a result that holds under alternative measure of state fiscal capacity.⁹²



The basic relationship portrayed above is well established in the literature. In a study published in 2002, Laurent and Vaillancourt also showed that U.S. federal grants did not have an equalizing effect.⁹³ The authors examined U.S. grant programs during the years 1989-90 and 1998-99, comparing per capita federal transfers to per capita personal income (PCPI) and per capita gross domestic product (PCGDP). In contrast to Canada, where the authors observed a strong and statistically

⁹² A similar relationship exists between per capita federal grants and fiscal capacity as measured by (1) per capita income, (2) the Representative Revenue System (RRS) methodology and (3) the Total Taxable Resources (TTR) methodology,

⁹³ Stephen Laurent and François Vaillancourt, *Federal Transfers in Canada and the United States, 1989-1990 to 1998-1999: How Equalizing Are They?*, NTA PROCEEDINGS, 95TH ANNUAL CONFERENCE OF NATIONAL TAX ASSOCIATION 203 (2002).

significant negative relationship between per capita federal transfers and these two measures of fiscal capacity ($r = -0.863$ for 1998-99 per capita GDP; $r = -0.873$ for 1998-99 per capita income), no such relationship was observed for the United States. For 1998-1999, the correlation coefficient was 0.062 for per capita federal transfers and per capita income and -0.115 for per capita federal transfers and per capita gross domestic product.⁹⁴

Note that the data from the Laurent and Vaillancourt study reflect federal transfers for *all* U.S. federal grant programs, consisting of more than 900 specific grant programs, 172 of which distribute federal grant money by formula.⁹⁵ By far the most significant federal grant program for the states is the Medicaid system, which accounted for \$108.6 billion of the \$267 billion in total federal transfers for 1998-99.⁹⁶ To better understand the disequalizing effects of U.S. federal grants, the following section considers the principal design features of the Medicaid grant system.

C. *Equalization via the U.S. System of Medicaid Grants*

Enacted in 1965 as part of Lyndon Johnson's "Great Society," Medicaid is by far the largest program of federal grants to the states.⁹⁷ For Fiscal Year 2005, total expenditures for the Medicaid program (state and local combined) were approximately \$300 billion. Of this amount, the federal share was \$170 billion, while the states spent \$130 billion.⁹⁸ For present purposes, we are interested in how the federal Medicaid grants are distributed among the states. More specifically, what is the relationship between the distribution of Medicaid grants and state fiscal capacity? Do states with lower fiscal capacity generally receive more assistance in Medicaid spending from the federal government than states with higher fiscal capacity?

⁹⁴ Id. at 207.

⁹⁵ Id. at 204.

⁹⁶ Id. at 205.

⁹⁷ For a political history of the Medicaid program see DAVID G. SMITH AND JUDITH D. MOORE, *MEDICAID POLITICS AND POLICY, 1965-2007* (2008).

⁹⁸ U.S. Department of Health and Human Services, Centers for Medicare and Medicaid Services, *Net Reported Medicaid and SCHIP Expenditures* (2005); See also Christine Scott, *Medicaid and the Current State Fiscal Crisis*, CRS REPORT FOR CONGRESS, CRS-4 (February 17, 2004).

Grants under the current Medicaid system are allocated to the states in accordance with a formula based on so-called “Federal Medicaid Assistance Percentages” or FMAP.⁹⁹ The formula is as follows:

$$FMAP = 1.00 - \left(\frac{\text{state per capita income}^2}{\text{U.S. per capita income}^2} \right) * .45$$

The first thing to note here is that the FMAP formula expressly incorporates a measure of fiscal capacity—i.e., relative per capita income. The inclusion of the .45 figure in the formula ensures that a state with average per capita income will have an FMAP of 55 percent. For example, in 2005, U.S. per capita income was \$34,650.¹⁰⁰ Rhode Island, with per capita income of \$35,507, had a 2005 FMAP of just over 55 percent. Deviations from the standard 55 percent match are thus a function of the state’s relative per capita income. In addition, squaring the per capita income figures has the effect of further increasing the FMAP of states with below-average per capita income and decreasing the FMAP of states with above-average per capita income.¹⁰¹

Given the FMAP formula’s explicit equalization feature, one might assume that the allocation of Medicaid grants among the states favors low-income jurisdictions. Indeed, as various commentators have noted, the FMAP formula “is intended to adjust for differences in state fiscal capacity and to reduce program benefit disparities across states by providing more federal funds to states with weaker tax bases.”¹⁰² Significantly, however, two features of the formula work to counteract its equalizing effects. First, and most importantly, Medicaid relies on a system of matching grants, so that a state must put up its own money before it is entitled to any federal money. States with higher fiscal

⁹⁹ Christine Scott, *Federal Medical Assistance Percentage (FMAP) for Medicaid*, CRS REPORT FOR CONGRESS, CRS-4 (March 1, 2005).

¹⁰⁰ Income data for the FMAP formula are per capita personal income figures published each year by Bureau of Economic Analysis.

¹⁰¹ For example, assuming an average U.S. per capita income of \$35,000, squaring the per capita income figures increases the FMAP of a state with per capita income of \$30,000 to 66.94 percent (from 61.43 without squaring) and decreases the FMAP of a state with per capita income of \$40,000 to 41.22 percent (from 48.57 without squaring).

¹⁰² *Options for Improving the FMAP Formula*, MAKING MEDICAID WORK FOR THE 21ST CENTURY, NATIONAL ACADEMY FOR STATE HEALTH POLICY, ISSUE BRIEF #3 (November 2004).

capacity.¹⁰⁵ These data suggest that Medicaid’s disequalizing features, including the matching requirement and the 50 percent FMAP floor, combine to overpower the effect of adjusting the formula for relative per capita income. As a result, the federal government’s most significant program of intergovernmental fiscal assistance has no equalizing effect.

D. *What Explains the U.S. Failure to Equalize?*

The foregoing analysis prompts a natural question. Given the pervasive use of equalization among the world’s federations, one might reasonably wonder why the United States has never adopted—and, indeed, has never even seriously considered adopting—an equalization policy at the federal level. The academic literature is not silent on this question, but a satisfactory explanation for the U.S.’s “outlier” status in this area has yet to emerge.¹⁰⁶ Part of the difficulty derives from the general problem of identifying the “cause” of something that never happened. If an equalization bill had been introduced in Congress, perhaps the debate over that legislation would provide some insight. Unfortunately, there is no evidence of proposed legislation so precisely on point. The root explanation for the U.S. “failure to equalize across the states”¹⁰⁷ is therefore largely a matter of historical speculation.

In the sole scholarly discussion of these issues, Kenyon and Kincaid discuss a litany of “political factors” and “normative issues,” including things such as the difficulty in defining fiscal capacity, the complexity involved in designing a suitable equalization formula and the tendency of Americans “to place more emphasis on ‘equality by opportunity’ than on ‘equality of result.’”¹⁰⁸ It seems plausible to assume these factors played some role in thwarting the emergence of an equalization regime in the United States. On the other hand, many of the factors and issues identified by Kenyon and Kincaid were also present in other countries that adopted equalization policies. In addition, it is not clear why these

¹⁰⁵ In contrast, *total* Medicaid outlays (i.e., the sum of federal Medicaid grants and state spending on Medicaid) are strongly positively correlated with state tax capacity.

¹⁰⁶ The sole academic treatment of this issue is an interesting essay published in 1996 by Daphne Kenyon and John Kincaid. See Daphne Kenyon & John Kincaid, *Fiscal Federalism in the United States: The Reluctance to Equalize Jurisdictions*, in FINANZVERFASSUNG IM SPANNUNGSFELD ZWISCHEN ZENTRALSTAAT UND GLIEDSTAATEN (1996). On the outlier status of the U.S., see Keen, *supra* note 1.

¹⁰⁷ Keen, *supra* note 1 at 779.

¹⁰⁸ Kenyon and Kincaid, *supra* note 106 at 46-51.

factors would frustrate the development of an equalization policy but not other U.S. policies that suffer from similar handicaps. Ultimately, the Kenyon/Kincaid discussion is too general to form the basis of a convincing explanation of the U.S. failure to equalize.¹⁰⁹

An alternative explanation, which I am exploring in separate work, concerns the role of the South in the development of the basic institutions of U.S. fiscal federalism. Because the South was (indeed, still is) the nation's poorest region, any system of equalization grants would have entailed large-scale transfers from the federal government to Alabama, Arkansas, Mississippi, and other state governments in the region. Yet for most of the 20th century, and, crucially, during the postwar years when the idea of fiscal equalization was first gaining prominence, controversy over civil rights and racial justice in these very states dominated the politics of American federalism. The result, I contend, was an atmosphere of charged political conflict that ruled off limits otherwise commonplace reforms to the country's fiscal institutions, including the sort of equalization regime that emerged in Canada and various other federations. To be sure, Southern lawmakers were never shy about laying claim to federal resources, but the epic clash over the future of Jim Crow ensured that economic assistance to the region was subject to certain political parameters limiting the form it could take.

For its part, the South plainly preferred fiscal support with as few federal strings as possible. As far as the region's lawmakers were concerned, preserving Southern "civil society" meant minimizing federal interference in the region's local affairs. At the same time, however, northern liberals had little interest in underwriting Jim Crow, and in any event usually preferred direct federal programs to strategies aimed at assisting state governments. Given these political constraints, it is not surprising that equalization did not appear on the nation's political agenda. Equalization grants of the sort observed in other countries—understood as a system of unconditional transfers to poor states, effectively financed by the nation's wealthier regions—were simply

¹⁰⁹ Certain economic historians have examined the political economy of U.S. fiscal federalism, but without focusing on the U.S. failure to equalize. See, e.g., John Joseph Wallis, *The Political Economy of New Deal Fiscal Federalism*, 29 *ECONOMIC INQUIRY* 510 (1991).

unthinkable in the U.S. as long as racial repression and segregation continued in the South.¹¹⁰

This is not to suggest that Southern lawmakers did not seek greater resources from the federal government. Indeed, as historian Bruce Schulman explains in a comprehensive history of the federal government's role in the economic transformation of the South, the region's political representatives sometimes even explicitly framed their arguments in the language of "equalization," bemoaning the preference for wealthier states implicit in the standard dollar for dollar matching formula used in most federal grants.¹¹¹ But the political solution to these agitations was not equalization of the sort observed in other federations, but rather the emergence of the "variable matching grant," which offered a higher percentage match for states with lower per capita income, chiefly in the South. Although Southern lawmakers had been pushing for that change in the late 1930s,¹¹² it wasn't until after World War II that Congress began adopting variable formulas in federal grants to the states. In the Hill-Burton Hospital Survey and Construction Act of 1946 Congress incorporated a grant allocation formula that would later serve as the basis for the Medicaid FMAP approach.¹¹³ Variable matching grants are now the dominant method of federal fiscal assistance to the states.

¹¹⁰ It is telling that in 1957, the same year that Canada first adopted its equalization program, President Eisenhower sent federal troops to Little Rock, Arkansas to integrate Central High School.

¹¹¹ BRUCE J. SCHULMAN, *FROM COTTON BELT TO SUNBELT: FEDERAL POLICY, ECONOMIC DEVELOPMENT, & THE TRANSFORMATION OF THE SOUTH, 1938-1980* (1994).*Id.* at 113-114 (citing southern officials' complaints regarding the effects of federal matching grants). Before the New Deal, most federal grants to the states were either flat amounts per state or variable grants based on state population. Typically, both types of grants were required to be matched by state funds. Reliance on matching grants expanded significantly during the New Deal, most notably via the Old Age Assistance (OAA) program enacted as part of the Social Security Act of 1935. As initially designed, the OAA system provided for a simple fifty-fifty federal match of state expenditures. *Id.*

¹¹² The first major battle over variable grants featured a congressional fight over an amendment to the Social Security Act of 1939 proposed by Texas Senator Tom Connally. The Connally amendment would have changed the formula for the allocation of old age assistance grants to the states, directing greater funding to the South, but it was rejected in the Conference Committee. *Id.*

¹¹³ Paul A. Brinker and Burley Walker, *The Hill-Burton Act: 1948-1954*, 44 *THE REVIEW OF ECONOMICS AND STATISTICS* 208 (1962).

III. WHAT WOULD A U.S. EQUALIZATION PROGRAM LOOK LIKE?

The analysis above has demonstrated the extent of fiscal disparities among the 50 states. In addition, it has shown that existing federal grants do not reduce these disparities and, in some cases, widen the gap in fiscal resources between rich and poor states. This Part will describe the results of two simulations of a Canadian-style system of fiscal equalization in the United States, using the fiscal capacity estimates from the fiscal capacity studies discussed above. The object here is to sketch out a rough picture of what a U.S. system of fiscal equalization grants would look like—i.e., how much such a program would cost, which states are the winners, which are the losers, etc.... In addition, this Part will briefly discuss certain “micro-reforms” that are consistent with the spirit of an equalization but fall short of full Canadian-style equalization program.

A. *Simulating Canadian-Style Equalization in the United States*

Recall that Canada uses a “representative tax system” (RTS) methodology in carrying out its equalization program.¹¹⁴ The first simulation uses the RTS methodology described in the November 2006 Tannenwald study, which is similar to the RTS methodology followed in Canada. The second simulation relies on the broader “representative revenue system” (RRS) methodology, which includes various non-tax sources of revenue in addition to the taxes used in the RTS system.

1. *Simulation of RTS Equalization in the United States*

Based on the average tax rates for 20 separate taxes, the U.S. average RTS tax capacity is \$3,726 per capita for fiscal year 2005. For purposes of the present simulation, this nationwide average is used as the standard against which each state’s per capita tax capacity is measured to determine whether a state is entitled to equalization payments. Accordingly, the specific amount of equalization payments to which a state is entitled is a function of (1) the difference between the state’s per capita tax capacity and the nationwide average, and (2) the state’s population. Based on the RTS methodology and 2005 tax capacity

¹¹⁴ *Supra* Part II.A.

estimates, the total cost of the program would be \$68 billion, or approximately one-half of one percent of U.S. GDP for 2005.¹¹⁵

As shown in Table 3 below, 29 states would be entitled to equalization payments. On a per capita basis, the five states receiving the largest payments would be Mississippi, West Virginia, Arkansas, Louisiana and Alabama. Thus, the implementation of Canadian-style equalization in the United States should be understood as a program that would principally benefit the South.

**Table 3: Per Capita Equalization Payments,
Simulation using RTS Methodology (2005)**
29 “Beneficiary States”
(ranked by size of per capita payment)

1. Mississippi (\$1,119)	9. Kentucky (\$632)	17. Indiana (\$371)	25. Wisconsin (\$178)
2. West Virginia (\$963)	10. Utah (\$613)	18. Kansas (\$344)	26. Maine (\$156)
3. Arkansas (\$834)	11. Tennessee (\$548)	19. Arizona (\$331)	27. Montana (\$132)
4. Louisiana (\$741)	12. New Mexico (\$480)	20. Pennsylvania (\$318)	28. South Dakota (\$130)
5. Alabama (\$729)	13. Texas (\$472)	21. Missouri (\$306)	29. Oregon (\$124)
6. Oklahoma (\$681)	14. North Carolina (\$451)	22. Nebraska (\$245)	
7. South Carolina (\$665)	15. Georgia (\$448)	23. Michigan (\$223)	
8. Idaho (\$644)	16. Ohio (\$413)	24. Iowa (\$183)	

Source: Yilmaz & Zahradnik (2008)

The regional effects are somewhat different when states are ranked according to the gross size of the equalization payment. On the basis of total equalization payments, the five states receiving the largest equalization payments would be Texas (\$10.8 billion), Ohio (\$4.7 billion), Georgia (\$4.1 billion), Pennsylvania (\$3.9 billion), and North Carolina (\$3.9 billion).

It is worth pausing to consider the how significant these equalization payments in the context of the budgets of beneficiary states. For example, with a per capita equalization payment of \$1,119, the state of Mississippi would receive a total equalization payment of \$3.25 billion. Based on total state and local government expenditures of \$20 billion, an equalization payment of \$3.25 billion would represent an increase of

¹¹⁵ U.S. GDP 2005 (\$12,421,900,000,000).

approximately 16 percent in resources available to the state of Mississippi and a 54 percent increase in federal transfers to the state.¹¹⁶

Significantly, given the unconditional nature of equalization payments, these amounts could be used for any purpose, including education, welfare, or even tax relief.¹¹⁷ Again, the point of fiscal equalization is not to promote any particular set of spending priorities, or even any particular level of government spending, but rather to reduce net fiscal benefit differentials among the states.¹¹⁸ In keeping with this objective, the resources may be used as local political preferences. Thus, in the same way that the federal government does not specify the tax and spending priorities of high capacity jurisdictions, an equalization policy modeled on the Canadian system would leave the disposition of equalization grants to the political discretion of beneficiary states.

2. *Simulation of RRS Equalization in the United States*

Recall that the chief difference between the RTS methodology and the RRS methodology is the inclusion in the latter of several non-tax sources of revenue, including lottery revenues, user fees and other government charges. Inclusion of these items in an equalization program raises several difficult methodological questions regarding how fiscal disparities should be measured. With conventional taxes, it is easy enough to determine a state's "tax capacity" since most taxes have a readily identifiable "base" that can be used to measure fiscal capacity. However, this is not the case for non-tax sources of revenue. For example, what is the appropriate "base" for determining a state's capacity for user charges and fees? In calculating revenue capacity under the RRS methodology, the authors of the Tannenwald study have used personal income as the hypothetical base against which to measure non-

¹¹⁶ Mississippi spending data are for 2005. The \$20 billion figure in the text represents combined state and local government expenditures. State & Local Government Finance Data Query System (available at www.taxpolicycenter.org). Federal grants to Mississippi for 2005 totaled \$6 billion.

¹¹⁷ The use of equalization payments to reduce provincial taxes sparked controversy in Canada in early 2007 when Quebec Premier Jean Charest did exactly that. See Les Whittington, *Harper's Generosity to Quebec Backfires: Provinces Angry After Charest Uses Equalization Payment to Cut Taxes*, TORONTO STAR (March 22, 2007).

¹¹⁸ See *supra* Part IB.

tax revenue capacity.¹¹⁹ As a result, an equalization program based on the RRS methodology instead of the RTS approach would tend to favor lower income states.

**Table 4: Per Capita Equalization Payments,
Simulation using RRS Methodology (2005)**

31 “Beneficiary States”

(ranked by size of per capita payment)

1. Mississippi (\$1,561)	9. Oklahoma (\$901)	17. Ohio (\$523)	25. Pennsylvania (\$319)
2. West Virginia (\$1,384)	10. Kentucky (\$898)	18. Indiana (\$505)	26. Michigan (\$306)
3. Arkansas (\$1,185)	11. New Mexico (\$812)	19. Kansas (\$458)	27. South Dakota (\$277)
4. Louisiana (\$1,138)	12. Tennessee (\$713)	20. Missouri (\$450)	28. Wisconsin (\$252)
5. Utah (\$976)	13. North Carolina (\$646)	21. Montana (\$429)	29. Oregon (\$195)
6. South Carolina (\$959)	14. Georgia (\$601)	22. Nebraska (\$336)	30. North Dakota (\$160)
7. Idaho (\$947)	15. Arizona (\$588)	23. Iowa (\$326)	31. Vermont (\$55)
8. Alabama (\$941)	16. Texas (\$559)	24. Maine (\$322)	

Source: Yilmaz & Zahradnik (2008)

The key thing to note regarding the RRS methodology, as compared to the RTS approach, is the magnitude of the payments to beneficiary states. Note, for example, that Mississippi, which would receive a per capita equalization payment of \$1,119 under the RTS approach, would receive an equalization payment of \$1,561 under the RRS approach. The larger payment under the RRS methodology is a function of the fact that the RRS approach equalizes a broader range of revenue instruments. Thus, the overall cost of an RRS equalization methodology would be substantially greater than an equalization program following the RTS methodology. Under the simulations above, the RTS approach would have an overall expense of \$68 billion per year, while the RRS approach would cost \$93 billion.

B. Adjusting for Regional Cost-of-Living Differentials

The analysis above has shown that the chief beneficiaries of a U.S. equalization regime would be the low-income states of the South (e.g., Mississippi, West Virginia, Arkansas, Louisiana), as well as certain Western states (e.g., Utah, Idaho, New Mexico). Based on this list, one might object that the simulations reported above take no account of the relatively low cost of living in beneficiary states as compared to states that would not receive equalization grants, such as New York, California or Massachusetts. One might argue that calculating grants by reference

¹¹⁹ Tannenwald Study, Appendix B, pages 48-49.

to average per capita tax or revenue capacity could “overcompensate” beneficiary states if price levels are systematically lower in the those jurisdictions.

At first blush, therefore, it would seem appropriate to make some adjustment to the equalization formula to account for those cost differences.¹²⁰ Upon reflection, however, the case for a cost of living adjustment is not as clear as it might first seem. For example, regional variations in housing values often reflect differential amenities.¹²¹ An oceanside home in Cape Elizabeth, Maine is likely to have a higher value than comparable real estate in Slaughter, Louisiana. Should Maine receive a larger grant, and Louisiana a smaller grant, to reflect the differences in housing values? On the one hand, the lower cost of living in Slaughter makes it possible to provide a typical bundle of state and local government services more cheaply there than in Cape Elizabeth. On the other hand, Cape Elizabeth’s higher cost of living carries with it the benefit of living in coastal Maine. Matters are complicated by the fact that, for many people, the high cost of housing is actually a *disamenity*, perhaps prompting them to demand higher wages as compensation for the higher rents or mortgage payments they must make. This is an argument commonly heard in debates over teachers’ salaries in high-cost cities like Los Angeles or New York. While there may be a strong case for paying government employees more in these and other high-cost jurisdictions, how an equalization formula (or any federal tax or transfer policy) should account for these differences is not clear.

Another complication relates to interstate differences in the cost of providing government services. On the one hand, it might seem appropriate to direct greater federal resources to states that face a higher

¹²⁰ For a discussion of the use of cost-of-living measures in a needs-based equalization regime, see Jameson Boex and Jorge Martinez-Vazquez, *Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices, and Lessons*, in *FISCAL EQUALIZATION: CHALLENGES IN THE DESIGN OF INTERGOVERNMENTAL TRANSFERS* (edited by Jorge Martinez-Vazquez and Bob Searle, 2007).

¹²¹ Louis Kaplow, *Regional Cost of Living Adjustments in Tax-Transfer Schemes*, NBER WORKING PAPER #5008 (1995) (“When regions differ in amenities, cost-of-living adjustments that otherwise seem plausible can become problematic or even counterproductive.”). See also Tom Griffith and Michael Knoll, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV. L. REV. 987 (2003).

cost of providing a standard bundle of public goods and services. On the other hand, interstate differences in the cost of providing government services are often a function of policy choices, such as the desire to increase salaries of government workers. An adjustment in the equalization formula to reflect the differential costs of government services would give states an incentive to increase the cost of those services, since doing so would draw in greater federal resources.

For purposes of the present analysis, I have used state-level CPI-U data provided to me by Robert Inman of the Wharton School of Business at the University of Pennsylvania.¹²² This cost of living index, which excludes differences in the price of housing and government services, is specifically designed to avoid the endogeneity issues discussed above. Table 5 reports the results of a simulation of the RTS equalization methodology, adjusted for state-level variations in CPI-U.¹²³ Under this approach, 33 states would receive an equalization grant and the total cost of the program would be approximately \$109 billion per year.

**Table 5: Per Capita Equalization Payments,
Simulation using RTS Methodology, Adjusted for CPI-U (2005)**
33 “Beneficiary States”
(ranked by size of per capita payment)

1. Mississippi (\$872)	10. South Carolina (\$594)	18. Tennessee (\$411)	26. Washington (\$334)
2. West Virginia (\$865)	11. Ohio (\$574)	19. Rhode Island (\$409)	27. Nebraska (\$316)
3. Idaho (\$829)	12. Arkansas (\$513)	20. Oregon (\$390)	28. Montana (\$311)
4. Utah (\$766)	13. Arizona (\$488)	21. North Carolina (\$362)	29. Michigan (\$294)
5. Oklahoma (\$711)	14. Pennsylvania (\$486)	22. Illinois (\$360)	30. Texas (\$266)
6. Indiana (\$690)	15. Louisiana (\$446)	23. Georgia (\$346)	31. Iowa (\$209)
7. Kentucky (\$689)	16. Maine (\$426)	24. Kansas (\$344)	32. Vermont (\$183)
8. New Mexico (\$663)	17. Missouri (\$411)	25. Wisconsin (\$336)	33. South Dakota (\$141)
9. Alabama (\$637)			

Source: Yilmaz & Zahradnik (2008)

Comparing the results shown in Table 6 above to those reported in Table 4 (RTS equalization, unadjusted for cost of living differences), there are several differences that deserve mention. First, when cost of living differences are taken into account, several of the Midwestern states receive substantially higher equalization payments. For example, Indiana,

¹²² Inman’s approach to calculating these data is discussed in Steven Craig and Robert Inman, *Federal Aid and Public Education: An Empirical Look at the New Fiscal Federalism*, 64 REV. ECON. STATISTICS 541 (1982).

¹²³ CPI-U is the Consumer Price Index for all Urban Consumers, published by the Bureau of Labor Statistics. For a discussion, see <http://www.bls.gov/cpi/cpifaq.htm>.

Missouri, Ohio and Pennsylvania receive larger grants in a cost-adjusted regime. Mississippi and West Virginia remain the top two beneficiary states, though certain of the other Southern states—most notably Louisiana and Arkansas—would receive substantially smaller grants. Finally, two Eastern states, Rhode Island and Vermont, would receive equalization grants in a cost-adjusted regime but not when using a methodology that takes no account of regional price differences.

It should be emphasized that the question of whether and how to adjust federal grants (or other fiscal policies, such as the federal income tax) for regional cost-of-living differences is extraordinarily complex. Partly for this reason, most federal fiscal policies do not currently take account of state cost differentials. Because of the uncertainties surrounding this issue, the simulations presented above should be regarded as preliminary and subject to further discussion.

C. Micro-Reforms in the Spirit of Equalization

Given the likely costs of a Canadian-style system of fiscal equalization grants and the political difficulty of enacting such a program, there is reason to be skeptical that the U.S. will adopt an equalization policy anytime soon. However, there are various other reforms, many of them more incremental in nature, which would be consistent with the principles of equalization. For example, such policies might include (1) the repeal or modification of the current federal income tax deduction for state and local taxes, or (2) modification of the formula for allocating Medicaid grants to take better account of the relative revenue-raising capacity of the states. Each of these reforms is discussed briefly below.

Repeal of the Deduction for State and Local Taxes. Under the current federal income tax, individuals are allowed to claim a deduction for taxes paid to state and local governments.¹²⁴ With one minor exception, the deduction is available only to taxpayers who elect to itemize their deductions for federal income tax purposes.¹²⁵ These are typically individuals with higher incomes. In addition, the value of the

¹²⁴ 26 U.S.C. §164(a). Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. REV. 1389 (2004).

¹²⁵ Under a law enacted in early 2008 and extended in the financial bailout legislation, non-itemizers may claim a deduction for property taxes for tax years 2008 and 2009.

deduction is a function of the taxpayer's marginal tax rate, which under current law rises with income. As a result, the deduction for state and local taxes is more valuable to high-income taxpayers than low-income taxpayers. On balance, these features of the current deduction for state and local taxes operate to ensure that the benefit of this federal tax expenditure goes principally to high-income residents of states with relatively high fiscal capacity, such as California, Connecticut, Massachusetts, New York and New Jersey. In fact, these five states, representing roughly 25 percent of the nation's population, account for 43 percent of the \$474 billion of itemized deductions for state and local taxes in 2006.¹²⁶ In other words, the lion's share of the federal subsidy is being used to defray state and local taxes paid by high-income taxpayers in states with the highest fiscal capacity.

Repeal of the deduction for state and local taxes would reduce the federal subsidy to residents of states with high fiscal capacity. In some sense, this repeal is already underway. State and local taxes are not deductible for purposes of the alternative minimum tax (AMT).¹²⁷ At present, a relatively small percentage of total income tax returns are subject to the AMT.¹²⁸ As the AMT grows in significance, however, the number of individuals in high fiscal capacity states benefiting from the federal subsidy for state and local taxes is reduced. In general, a far greater number of AMT taxpayers are residents of high fiscal capacity states than low capacity states. Aside from repeal, certain other reforms to the deduction for state and local taxes could serve an equalization function. For example, converting the subsidy from an itemized deduction to a flat-rate refundable credit would likely benefit taxpayers in low-capacity jurisdictions, while reducing the subsidy for taxpayers in high-capacity jurisdictions.

¹²⁶ IRS Statistics of Income, *Table 2, Individual Income and Tax Data by State, Tax Year 2006*, Row 47 of Excel spreadsheet (available at <http://www.irs.gov/pub/irs-soi/06in54cm.xls>).

¹²⁷ 26 U.S.C. sec. 56.

¹²⁸ For tax year 2006, a total of 2.96 percent of individual income tax returns owed AMT. This is the nationwide average. The number varies by state. The highest is New Jersey, where 6.47 percent of all returns are subject to the AMT. 8.84 percent of *taxable* returns in New Jersey were subject to the AMT in tax year 2006, compared to 4.34 percent nationwide. See *Alternative Minimum Tax by State, Tax Year 2006* (available at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=536>).

Modification of Medicaid’s FMAP Formula. Another possible micro-reform in the spirit of fiscal equalization would be a modification to the current formula used to allocate federal Medicaid grants among the states. As discussed above, current law determines a state’s Medicaid grant by reference to its “federal medical assistance percentage,” or FMAP. This percentage is calculated by reference to the state’s relative per capita income, resulting in an increased FMAP for low-income states and a reduced FMAP for high-income states. However, the statute establishes a 50 percent floor so that states with high per capita income will never fare worse than a fifty-fifty matching rate under the statute.

Various reforms to the FMAP formula have been proposed to take better account of the relative fiscal capacity of the states in the allocation of federal resources. In separate work, I have estimated the effects of certain reforms to the FMAP formula, including replacing per capita income with alternative measures of fiscal capacity, such as the RTS, RRS and TTR methodologies described above.¹²⁹ Public finance experts generally regard these alternative methodologies as superior measures of fiscal capacity than simple per capita income figures, mostly because they offer a broader definition of economic resources available to a state. Incorporating one of these alternative measures into the FMAP formula, in lieu of per capita income, would have the effect of decreasing the share of Medicaid dollars currently directed to states with relatively low income but high taxable resources, including Florida, Nevada, Hawaii, Alaska and Wyoming.¹³⁰ In addition, several states, especially in the Midwest, have relatively weaker tax bases. A more significant reform to the FMAP formula would be to eliminate the 50 percent statutory floor for high-income states, which currently has the effect of increasing Medicaid grants to twelve states with the highest fiscal capacity.¹³¹

Equalization “Vouchers” or Tax Credits. Finally, recall that the ultimate targets of an equalization regime are not states themselves, but rather the individuals who experience adverse fiscal treatment by virtue of residence within a particular state. Thus, one could imagine an equalization regime that bypasses state governments completely and

¹²⁹ Kirk J. Stark, *Rethinking the Equalization Component of Medicaid Grants* (November 2008) (unpublished manuscript on file with author).

¹³⁰ *Id.*

¹³¹ *Id.*

instead delivers equalization payments directly to individuals via “vouchers,” tax credits or some other type of cash grant.¹³² These “equalization vouchers” can be thought of as the equivalent of a cash grant made to the state that is subsequently remitted to state residents via tax rebates or subsidies. In this case, however, the federal government would be deciding the distribution of the grant money among individuals within the state, rather than leaving it to state lawmakers. Of course, a state could always “tax back” some or all of the equalization voucher received by its residents, a possibility that drives home the basic equivalence of grants to states and grants to states’ *residents*; however, it seems likely that the politics of individual grants would be different from the politics of grants to the states.

CODA—EQUALIZATION AS POST-PARTISAN FISCAL FEDERALISM?

This article has considered the possibility of the U.S. adopting a system of equalization grants, a commonplace fiscal policy adopted by nearly all of the world’s federations. It has described and evaluated the design of such a program, using the Canadian “representative tax system” methodology as a basis for estimating the program’s cost and distributive effects. Among the article’s principal conclusions is the finding that a U.S. equalization policy would chiefly benefit the so-called “red states” of the American South. On a per capita basis, the principal beneficiaries include Mississippi, West Virginia, Arkansas, Louisiana, Alabama. In terms of gross payments, a U.S. equalization policy would deliver its largest benefit to Texas.

As any student of American electoral politics will immediately recognize, these results suggest that a U.S. equalization policy would strongly favor the so-called “red states” that have favored Republican candidates in the past several presidential elections. Indeed, of the overall \$68 billion cost of adopting a Canadian-style RTS equalization program, fully \$48 billion, or 70 percent of the total, would go to red states. Nineteen of the 29 “receiving” states in such a program would be red states. All of the top ten receiving states (in terms of per capita

¹³² By “vouchers” I do not mean coupons or other evidence of the right to purchase some good or service, but rather simply a cash grant made available to citizens of jurisdictions with low fiscal capacity.

payments) were states won by Bush and McCain in the 2000, 2004 and 2008 elections.¹³³

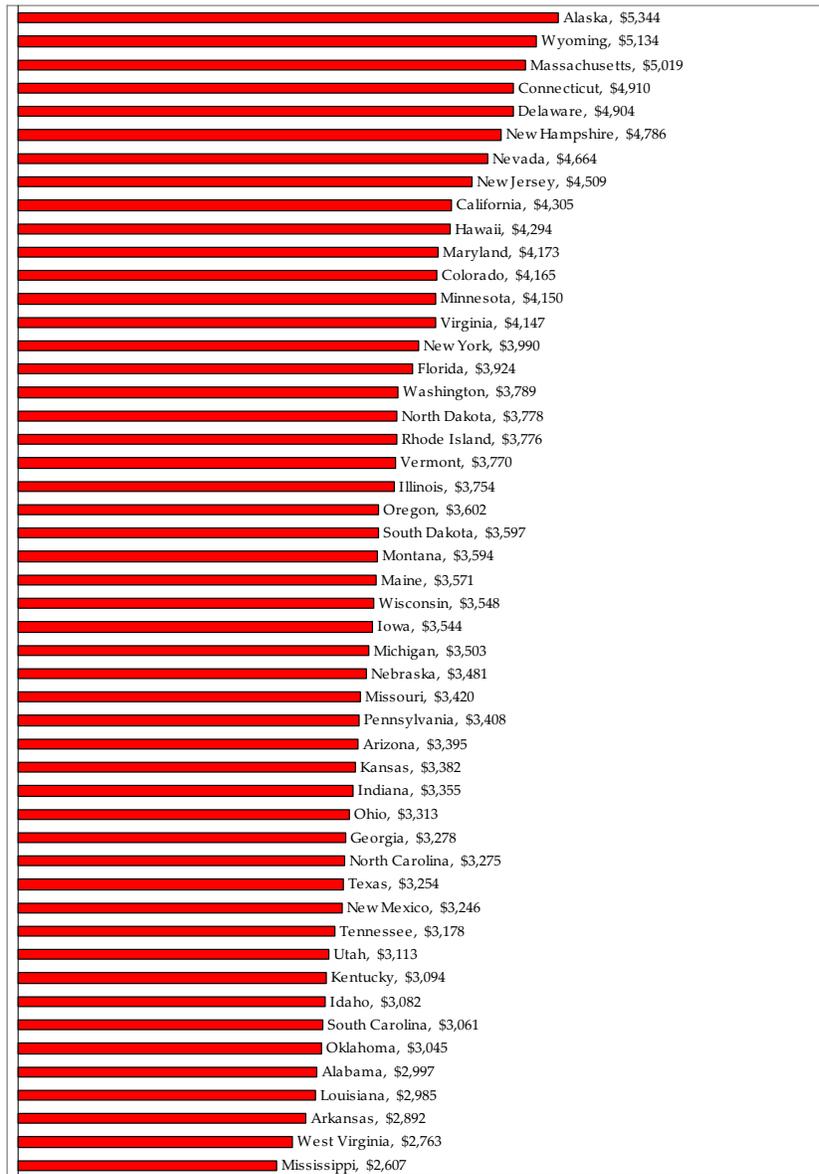
The fact that a U.S. equalization program would strongly favor Republican-leaning states might lead some to dismiss the policy as falling on the wrong side of the red-blue divide, now that Democrats control the White House and both chambers of Congress. After all, as New York Senator William Marcy famously quipped, “to the victor belong the spoils.” Yet the nation’s most recent victor, President Barack Obama, has expressed an alternative vision, calling for “a new kind of politics, one that can excavate and build upon those shared understandings that pull us together as Americans.”¹³⁴

Is it possible that a U.S. fiscal equalization policy might have something to contribute to this new kind of politics? Could a system of large-scale federal transfers to states like Mississippi and Texas serve these “post-partisan” objectives? It is tempting to dismiss this kind of thinking as Pollyannaish political rattle. On the other hand, a properly designed equalization regime—one that directs unconditional federal grants to those states with the weakest fiscal capacity—might help to “excavate and build upon those shared understandings that pull us together as Americans” precisely because it serves no obvious partisan function. Allowing states to provide “reasonably comparable levels of public service at reasonably comparable levels of taxation” admits of no particular bias in favor of one set of priorities over another. Instead, it endorses only a principle of equality of fiscal opportunity, leaving to 50 separate political communities the question of how, or even whether, that opportunity should be exploited.

¹³³ These results are consistent with the trend over the past several years for “rich” states to favor Democratic presidential candidates and “poor” states to favor GOP candidates, a phenomenon that has been much discussed of late. See THOMAS FRANK, *WHAT’S THE MATTER WITH KANSAS?* (2004). See also Larry Bartels, *What’s the Matter with What’s the Matter with Kansas??* (2005). See also Gelman, Shor, Bafumi & Park, *Rich State, Poor State, Red State, Blue State: What’s the Matter with Connecticut?* (2006). The study has now been published in book form. See ANDREW GELMAN et al, *RED STATE, BLUE STATE, RICH STATE, POOR STATE: WHY AMERICANS VOTE THE WAY THEY DO* (Princeton University Press, 2008).

¹³⁴ BARACK OBAMA, *THE AUDACITY OF HOPE: THOUGHTS ON RECLAIMING THE AMERICAN DREAM* (2006).

Figure 3: Per Capita State Tax Capacity, RTS (2005)
U.S. Average: \$3,726



Source: Yilmaz and Zahradnik (2008)