FISCAL FEDERALISM IN STRESS

by

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On the morning of June 7, 1978, the U.S. awoke to discover that they were in the midst of a "revolution." No, men and women were not called to arms. Cannons were not primed to be fired. Nor were ships, airplanes, or missiles prepared to be launched. This was not a bloody revolution. This was a "Tax Revolution." Proposition 13 had passed in California. With this news, voters across America were called upon to follow California's lead. They were called upon to "pull in their belts," to get the "fat out of the government," and to demand a "smaller," more efficient public sector which would "not compete with the interests of the private sector."

Proposition 13

This disarmingly simple referendum - known as the Jarvis-Gunn Amendment - turned state and local finance on its ear. In only 389 words it took the single most important source of local tax revenue and reduced it by 57 percent! In a single stroke, it saved Californians some \$7 billion in property taxes. It limited the taxes levied on real property - houses, farms, factories, businesses, and vacant lots - to one percent of assessed value. Then it rolled back that assessed value from 1978 levels to those that existed in 1975-76 and froze them at that level until the property owner sold the property. To insure that the taxpayer would not soon be harassed by increases in property taxation, it limited future increases in the tax levy to a mere two percent a year. For added comfort, it bound the State Legislature with a Constitutional Amendment and mandated that a two-thirds majority of both houses was needed to increase any other tax in California.

This radical legislation might leave the impression that there was a tax revolt in California. The fact is that although taxpayers in California were in revolt, their concerns were very narrowly focussed and very unique to California. Unfortunately for the rest of us, conservatives across the country argued that the success of the Jarvis-Gunn Amendment in California was proof that voters in every state had had enough of all taxes and enough of all government programs.

Conservatives won the day of course. Proposition 13 proved to be the single most important event for state and local governments in the post-depression period. But before those conse-

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quences are detailed, pause for a moment and speculate on why Californians were so upset on June 6, 1978. Speculate on why they cast ballots that set this revolution in motion. In order to appreciate fully the actions taken by California voters in the summer of 1978, those actions should be placed in historical context. First, it must be remembered that for the two decades prior to the referendum, Californians paid a higher percentage of their income in state and local taxes than the residents of most other states. This tax burden became particularly onerous in those years immediately preceding Proposition 13. As Tables I and II indicate, relative to other states, taxes in California were high and they got higher as we approach 1978. For example, in 1967 tax effort in California was the 9th highest tax effort of any state in the union. By 1975 their tax effort ranked them third and in 1977, one year prior to Proposition 13, they were ranked fourth. Thus, over the years state and local taxes across the country increased, but they increased much faster in California prior to Proposition 13. In fact there were some spectacular increases in California during the mid 1970s. In 1975, 1976 and 1977, California's property taxes leaped forward at an annual 20 percent rate. The impact of Proposition 13 is obvious. One year after its passage, the tax effort of Californians was twenty-fifth out of the fifty states.

It should also be remembered that although tax effort was high in California, tax capacity - was also high. In essence, California had the income to pay high taxes and for a number of years they consciously chose to tax that income. As Table II details, California was, is, and will be in the foreseeable future, a very wealthy state.

If California residents exert a modest tax effort, given their luxurious tax base, they generate far more dollars in tax receipts than the average state. If they chose, as they did all through the 1960s and 1970s, to exert a high tax effort, given this immense tax capacity, their tax base generates extraordinary sums of money. In the case of California, the extraordinary sums of money that were actually generated by their tax system not only bought a first rate bundle of government services, but the ire of the conservative community as well.

What is ironic however, is that the ire generated by high service and tax levels in California was not the real cause for the passage of Proposition 13, even though taxes and expenditures were clearly high even by California standards just prior to 1978. Other, more important, forces were at work.

California, along with the rest of the nation, suffered from the worst bout of inflation that had been experienced since the early 1950s. In a high growth region like California, this inflation was manifested in rising money wages and rapidly escalating property values. Herein lies the problem. Since California's personal income tax is progressive, it is a relatively income elastic source of revenue. If, as in the case of California, a 5 percent increase in income was coupled with a 10 percent rate of inflation, the taxpayer faced double jeopardy. The taxpayer's purchasing power or real income before taxes fell

and after-tax income was further reduced by the higher marginal rates of taxation.

Table I

State and Local Taxes as a Percent of Personal Income

Year	Tax Effort Index	California's Rank out of Fifty States
1967	108	9 th
1975	119	3 rd
1977	117	4 th
1979	95	25 th
1980	102	19 th
1981	100	19 th

Source: 1981 Tax Capacity of the Fifty States (Washington D.C.: Advisory Commission on Intergovernmental Relations, 1983) Table 6, p. 12.

Table II

Tax Capacity in California Compared to Other States

Year	Tax Capacity Index	California's Rank out of Fifty States
1967	124	3 rd
1975	110	9 th
1977	114	7 th
1979	116	5 th
1980	117	6 th
1981	115	8 th
1982	116	5 th

Sources: 1981 Tax Capacity of the Fifty States (Washington D.C.: Advisory Commission on Intergovernmental Relations, 1983) Table 2, pp. 2-3.

Steven D. Gold, State Fiscal Indicator (Denver: National Conference of State Legislatures, 1982) Table F-2, P. 76.

But in the California case, this is only one of the consequences of inflation. Taxpayers across the country have incurred this consequence without loud complaint. Few taxpayers are sophisticated enough to disentangle the effects of inflation on their "real" after tax income. Taxpayers are, however, sophisticated enough to disentangle the effects of inflation on their property tax. Given California's very efficient property tax assessment program, increased property values which resulted from economic growth and inflation, were annually translated into increased property tax bills. Unlike the income tax, there were no smoke and mirrors to dazzle the taxpayer. They knew they were worse off. Once a year, in one lump sum, their property tax liability increased. Indeed, in the case of California, the assessed value of residential property increased 20 percent a year for each of the two years preceding Proposition 13. This very, very rapid increase in assessments not only increased the tax responsibility of homeowners, but it increased the relative tax burden of residential property compared to commercial-industrial property. This shift in relative tax burden can be traced to the fact that residential property changes ownership far more frequently than does non-residential property and these market transactions provide the assessors "market tests" on which to base their assessments. These market tests are rarely available for commercial-industrial assessments. As a consequence, assessors tend to under-assess these properties compared to residential property.

This is still not the end of the story. In California, the state's share of the costs of public schools was tied to local property tax assessments. As these assessments were inflated, state assistance to local school systems fell dramatically. Therefore, communities were forced to replace these lost state funds with the local property tax levy.

It can now be seen more clearly what the voter saw as they entered the voting booth in the summer of 1978. A dramatic shift in financing public schools in California was underway. School finance, a major expenditure category, was becoming less and less dependent on state income and consumption taxes and more and more dependent on the despised local property tax. This shift in the burden of school finance ran counter to recent trends in both California and the nation.

This shift in expenditure responsibility did more than simply increase property taxes. It resulted in the state government falling heir to an immense budget surplus. That is, the elastic state revenue system automatically generated more and more tax dollars as money incomes increased and the state expenditure responsibility automatically decreased because of the school finance formula. If all else was constant, the budget had to go into a major surplus. This is what happened: The accumulated state budget surplus increased from about \$500 million in 1976 to more than \$7 billion at the end of 1978!

Property taxpayers were furious. Rising prices were eroding their purchasing power. State and local tax increases were eroding their purchasing power. New property tax assessments which shifted fiscal responsibility away from broad based taxes

and commercial-industrial properties were eroding their purchasing power. And on top of this, there was the State with a \$7 billion dollar surplus. Howard Jarvis with his 389 word Constitutional Amendment sounded more and more appealing: "pull in your belt," "get the fat out of government," and let's have a smaller, more efficient government which doesn't compete with the interest of the private sector." Taxpayers could stop this California madness. They could make the State give them back the tax dollars they were hoarding in Sacramento. Equity between local governments and the State government and between residential taxpayers and non-residential tax payers could be restored. You could, perhaps quite inadvertently, start a tax revolution.

Other State Control Legislation

And start a tax revolution they did! Within a few short months, state after state placed tax expenditure referendum before their voters. The papers were filled with news of Michigan's Headlee Amendment, Massachusetts' Proposition 2 1/2 and Florida's Proposition 1. Within five years after the passage of Proposition 13, twenty-two states placed thirty new fiscal controls on their cities, counties and school corporations. In addition, seventeen states placed controls on their own spending and/or taxing powers.¹

As Table III indicates, the twenty-two states that employed new control measures on their local government typically attempted to limit property tax collections: three states limited the aggregate rate that is applied to assessed valuation, eleven states imposed a ceiling on the property tax levy-the total dollar amount collected by the property tax, four states placed controls on the assessment of property, and five states mandated that property tax liability be fully disclosed to the taxpayer. In addition to these explicit property tax controls, four states limited the total tax collections of their local governments.

Not satisfied with the fiscal constraints imposed on their local governments, many of these same states plus a few other states took steps to limit their own taxes and/or expenditures. Table IV clearly shows that most of these new state controls came shortly after the implementation of Proposition 13 - that is, twelve of the seventeen controls, were passed in 1978-1979 and only five were enacted in latter years. Table IV also indicates that unlike local controls, the state controls generally - 13 out of the 17 - limited expenditures and typically they were tied to the rate of growth of personal income in the state. A few states, such as Alaska, California and Nevada were exceptions to this rule. These states tied their expenditure controls to the growth rates of inflation and population. Lastly, it should be noted that there appears to be a tendency away from binding the state with a constitutional provision. Only the state of Missouri has chosen that route after the first wave of fiscal controls subsided.

By 1983, the fever pitch markedly subsided. However, in 1984 citizen groups continued to prepare new control

Table III
Recent Tax and Expenditure Controls on
Local Governments (1978-1983)

<u>State</u>	<u>Nature of Control Revenue/Expenditure</u>	<u>Character of Limits</u>
Alabama	Revenue	property tax rate limit
Arizona	Revenue and Expenditure	general expenditure limit and limit on assessment increases
Arkansas	Revenue	property tax levy limit
California	Revenue and Expenditure	property tax rate and levy limits, limit on assessment increases, and general expenditure limit
Colorado	Revenue	full disclosure
Delaware	Revenue	property tax levy limit
Florida	Revenue	property rate limit
Idaho	Revenue	property tax levy limit and general revenue limit
Indiana	Revenue	property tax levy limit
Kentucky	Revenue	full disclosure
Louisiana	Revenue	property tax levy limit
Maryland	Revenue	general revenue limit
Massachusetts	Revenue	property tax levy limit
Michigan	Revenue	property tax levy limit and full disclosure
Mississippi	Revenue	property tax levy limit and general revenue limit
Missouri	Revenue	general revenue limit
Nebraska	Revenue	general revenue limit
New Mexico	Revenue	property tax levy limit
North Dakota	Revenue	property tax levy limit
Oregon	Revenue	limit on assessment increases
Tennessee	Revenue	full disclosure
Texas	Revenue	limit on assessment increases and full disclosure

Source: Significant Features of Fiscal Federalism 1982-83 Edition,
(Washington D.C.:Advisory Commission on Intergovernmental
Relations, January 1984) Table 65, p. 98.

initiatives. In at least five states referendum were prepared for the 1984 November elections: (i) an attempt to eliminate the 7.5% income tax surcharge in Massachusetts; (ii) a proposed roll-back of all state tax increases since 1981 in Michigan coupled with a voter approval initiative; (iii) a Florida proposal to limit all state/local revenue increase to 2/3 the increase in the Consumer Price Index; (iv) a new property tax control in Oregon which would place a 1 1/2% ceiling on the

Table IV

Recent Tax and Expenditure Controls on State Governments

Year	State	Nature of Control Revenue/Expenditure	Characteristics of Limits	Legal Force
1978	Arizona	Expenditures	Maximum of 7% of personal income	Constitutional
1978	Hawaii	Expenditures	Rate of growth of personal income	Constitutional
1978	Michigan	Revenues	Fixed rates of revenue to personal income	Constitutional
1978	Tennessee	Expenditures	Rate of growth of personal income	Constitutional
1978	Texas	Expenditures	Rate of growth of personal income	Constitutional
1979	California	Expenditures	Rate of growth of inflation and population	Constitutional
1979	Colorado	Expenditures	Maximum of 7% annual growth	Statutory
1979	Louisiana	Revenues	Rate of growth of personal income	Statutory
1979	Nevada	Expenditures	Rate of growth of inflation and population	Statutory
1979	Oregon	Expenditures	Rate of growth of personal income	Statutory
1979	Utah*	Expenditures	85% of the rate of growth of personal income	Statutory
1979	Washington	Revenues	Rate of growth of personal income	Statutory
1980	Idaho	Expenditures	Maximum of 5.75% of personal income	Statutory
1980	Missouri	Revenues	Fixed ratio of revenue to personal income	Constitutional
1980	S. Carolina	Expenditures	Rate of growth of personal income	Statutory
1981	Montana	Expenditures	Rate of growth of personal income	Statutory
1982	Alaska	Expenditures	Rate of growth of inflation and population	Statutory

* This legislation did not become effective because supporting legislation was not adopted.

Source: Significant Features of Fiscal Federalism, 1982 - 83 Edition, (Washington D.C.:Advisory Commission on Intergovernmental Relations, January, 1984) Table 66, p.99.

effective property tax rate in that state; and (v) one more Howard Jarvis Constitutional Amendment which would close the "loopholes" which were opened in the litigation surrounding Proposition 13.

The new wave of attempts to control state and local revenues came in response to the state tax increases which were enacted in 1981, 1982 and 1983. Forty-seven of the fifty states passed new tax laws in these years - only Georgia, Texas and Hawaii did not impose new revenue measures. These tax increases were needed to replenish revenue reserves which were depleted by the Reagan program acts and the Reagan recession of 1982-83.

These tax increases are summarized in Table V. Thirty-four states increased taxes in 1981, twenty-five states increased taxes in 1982 and forty-one states raised at least one tax in 1983. In this short period of time, a total of 236 separate tax increases were enacted. In the first attempts to close the revenue gap, states turned to their excise taxes on cigarettes, alcohol and motor fuel² - in 1981, 69.2% of all tax increases were excise taxes - but as the severity of the revenue gap became more obvious, states were forced to increase their broad based sales and income taxes.

Table V

State Tax Increases in 1981, 1982 and 1983

	Income Taxes	Sales Taxes	Business Taxes	Cigarette Taxes	Alcohol Taxes	Motor Fuel Taxes	Misc. Taxes	Total
81	1	5	3	6	15	24	11	65
82	9	10	5	9	4	6	6	49
83	18	16	16	18	15	19	20	122
Tl.	28	31	24	33	34	49	37	236

Source: Significant Features of Fiscal Federalism 1982-83 Edition, (Washington D.C.: Advisory Commission on Intergovernmental Relations, January, 1984) Table 38, p. 52.

The importance of broad based taxes in attempts to close the revenue gap was captured by the Advisory Commission on Intergovernmental Relations. They have prepared a table entitled "A Barometer of Fiscal Pressure" which is reproduced here as Table VI. The Advisory Commission identifies three distinct time periods: i) Period of Program Growth (1959-1977); ii) Period of Tax Revolt (1978-80); and iii) Period of Recession (1981-83). In the 1959-77 phase there was a marked increase in the use of the personal income tax and the retail sales tax. Indeed, by 1977, forty-five states had turned to the sales tax and forty-three states were taxing at least one source of income. Of course this phase was followed by the tax revolt which is marked by 35 reductions in income taxes and 19 reductions in sales taxes. Lastly

their Period of Recession shows the policy reversal where state tax increases abound.

Table VI
A BAROMETER OF FISCAL PRESSURE
(State Personal Income and Sales Tax Legislative Actions)

	<u>Personal Income Tax</u>	<u>Sales Tax</u>	<u>Commentary</u>
<u>Period of Program Growth</u>			
<u>1959-1977</u>			
New Tax Adoptions	13	12	A steady strengthening of state tax systems to underwrite real expenditure growth.
Tax Increases	75	76	
Tax Decreases	N/A	N/A	
<u>Period of Tax Revolt</u>			
<u>1978-1980</u>			
New Tax Adoptions	--	--	Sharp contractions in state tax powers.
Tax Increases	2	6	
Tax Decreases	35	19	
<u>Period of Recession</u>			
<u>1981-1983</u>			
New Tax Adoptions	--	--	Dramatic tax hikes to offset recession-induced revenue losses. No countercyclical aid from Washington.
Tax Increases	28	31	
Tax Decreases	2	1	

Calculations not only count state tax rate increases and decreases, but also include adoptions and extensions of temporary tax changes, major changes in personal exemptions or credits or standard deductions, indexation of personal income taxes, tax rebates, elimination of taxes, and changes in major tax exemptions.

Source: Significant Features of Fiscal Federalism 1982-83 Edition, (Washington D.C.: Advisory Commission on Intergovernmental Relations, January, 1984) Table 39, p. 53.

The Carter Budget

The fiscal controls that states rushed to place upon their local governments and their own taxing and spending powers are not the only legacies of Proposition 13. Far more important is the reactionary mood that this legislation excited. As more and more states turned to tax-expenditure limitation schemes, Federal policy makers began to sense the shift in public opinion and in turn they began to adopt more fiscally conservative positions.

As early as 1978, Democrats joined their Republican colleagues in a call to re-examine the growth of domestic spending programs, including the entitlement programs. These programs,

particularly the entitlement programs, seemed to have taken on a life of their own. Not only did they continue into the future without Congressional review and reauthorization, but they continued on an ever-expanding scale. The net result was that Federal government spending as a percent of Gross National Product inched upward at an alarming rate. In the decade 1951-60 it averaged 18.7%, then in the following decade 1961-70, it rose to 19.5%. By the 1970s, it was averaging 21.5%.

A consensus was formed. It was time to rein in the public sector with its extravagant spending habits. No longer were programs such as CETA (Comprehensive Employment Training Act), subsidized housing programs, AFDC (Aid to Families with Dependent Children), child nutrition programs, the food stamp program, and mass transit aid, looked upon favorably. Now even extended unemployment benefits, veterans programs, and SSI (Supplementary Social Insurance) began to come under close scrutiny. Just as the clarion call had gone out to State Houses, now that same call went to Capitol Hill. We must "pull in our belts," we must "get the fat out of government," we must demand a "smaller," "more efficient" public sector which would "not compete with the interests of the private sector."

There was no need to wait for the election of a conservative Republican administration in 1980. A Democratically controlled Congress led by a Democratic President would take the first, bold steps.

In the words of President Carter:

This budget for fiscal year 1980 is lean and austere. It recommends a spending level well below that suggested by the recent momentum of Federal spending. It will disappoint those who seek expanded Federal efforts across the board. It meets my commitment to a deficit of \$30 billion or less.³

Carter had few options. He had battled the twin evils of unemployment and inflation in the first two years of his administration. His strategy was to stimulate the economy in the hope that this would directly reduce the level of unemployment and indirectly reduce the level of inflation by increasing the quantity of goods and services which were available in the market-place. His efforts were only partially rewarded. Unemployment fell from a high of 8 percent to 5.8 percent by the end of 1978. But this increase in economic activity had no depressing influence on inflation. Price increases hovered just below the double digit level in 1978 and threatened to gallop off into the stratosphere during the last two years in office. Thus faced with the potential of raging inflation on one hand and the reality of a fiscal conservatism which was raging through state after state on the other, President Carter drafted a budget which was "lean and austere."

In absolute terms, the fiscal year 1980 budget provided for a 7.1 percent increase in non-defense expenditures. In real terms, once adjustments for anticipated inflation were taken into

consideration, this budget would leave non-defense expenditures in 1980 at about the same level as they were in 1979 and in 1978. Perhaps of even more importance is the realization that to hold the line across the board in 1979 and again in 1980 meant that some programs were allowed to grow and that other programs were cut in absolute terms.

Although the image of David Stockman wading through government programs swinging a long, curved scythe is burned into our minds, the grinning Jimmy Carter with his soft southern drawl was responsible for first taking the scythe out of the barn. He proposed a hospital cost containment scheme that would reduce Federal expenditures by \$1.7 billion in 1980 and as much as \$9.2 billion by 1984. To the surprise of many, he called for cuts in the most sacred of sacred cows: the social security system. He would have dropped the lump-sum death benefit, phased out the student benefits for those over the age of eighteen, eliminated the flat \$122 minimum benefit, and taken several other steps which were estimated to cut federal expenditures by \$700 million in fiscal 1980 and \$4.4 billion in 1984. Of course, Congress rejected this set of proposals outright.

Far more significant for our purposes were Carter's plans for grants to state and local governments. In the decade prior to 1978, when grants-in-aid reached their peak in terms of the percentage of state/local expenditures supported by Federal dollars, the dollar value of these grants rose nearly fourfold (\$20.3 billion in 1969 to more than \$80 billion in 1978). In percentage terms, this means that the Federal government supported about 17.4 percent of all state and local expenditures in fiscal year 1969 and that this federal "contribution" increased to 26.7 percent in 1978. This raised serious questions, particularly among conservatives, as to whether or not state/local governments could act fiscally responsible when one out of every four dollars they spent was a gift from the Federal government.

Much attention in this regard was focussed upon general revenue sharing (the State and Local Fiscal Assistance Act of 1972). As Walter Heller and other early proponents of this unconditional grant program argued,⁴ this program was intended to share the federal largess with the financially strapped state and local governments. The logic was simple. Since the tax base of the federal government was far more income elastic than the tax base of state/local governments, the "fiscal dividend" generated by the federal tax base should be shared with the poor relatives in the state and local governments.

Additionally, if the distribution formula was weighted so as to benefit poor states and states with high tax efforts - states where taxes per \$1,000 of income were high - this grant-in-aid program could help to equalize income between states of varying fiscal capacity and to relieve some of the fiscal burden from those state and local governments with high tax efforts.

Walter Heller and his friends did not get all they wanted when Congress finally passed this program in 1972. Instead of a permanent sharing of funds - a permanent program would have allowed state and local governments to do more long-run planning

- Congress authorized funds for a five year period which ended in 1977. The bill was then renewed for another three years. During this eight year period, general revenue sharing deposited about \$6 billion a year in the coffers of state and local governments. These are large sums; but note, they are nowhere near what would have been transferred from the Federal government if Heller and his associates had been able to persuade Congress to dedicate a portion of the Federal tax base to this program.

Nevertheless, by budget time in fiscal year 1980, general revenue sharing became one of Carter's targets. he proposed to renew this program, but to renew it only for local governments, not state governments. Thus Congress passed a modified general revenue sharing program in 1980, which was extended for yet another three years in 1983. But instead of transferring \$6 billion a year, now the program transferred \$4.5 billion a year. Rather than sharing with both state and local governments, now this program only shares with local governments.⁵

President Carter didn't stop with cuts in general revenue sharing. He recommended reductions in grants for local public works projects, public service employment and counter-cyclical revenue sharing. This last set of grant programs had been put in place as temporary offsets for the 1974-75 recession. But, as should be expected, states, cities and counties who were the beneficiaries of these grants soon came to rely upon them and certainly came to resist any attempts to eliminate them.

The bottom line is that the Carter administration sounded a loud and clear warning. The Federal government would no longer underwrite a larger and larger share of state/local expenditures. Indeed, if Carter had his way, and if those who were to follow had their way, Walter Heller's grand scheme would be scrapped and the Federal government would underwrite a smaller and smaller share of state and local expenditures in the future.

The Reagan Plan

Carter's lean and austere budgets were but child's play compared to what was to follow. As Ronald Reagan swept into office in January 1981, pulling behind him on his long coattails many first term conservative members of the House and Senate, this new President uttered the now well rehearsed Howard Jarvis call: "tighten your belt," get the "fat" out of government, make the public sector "smaller", "more efficient so that it won't compete with private interests." But this time, unlike California and the previous Presidential Administration, this administration meant business. They claimed a mandate and they meant to use it.

By the time he took office, no one should have wondered about the course of public policy under the Reagan Administration. He stated his intentions repeatedly as he campaigned for office. But in the event that doubts still lingered, they were dispelled in his Inaugural Address. Here, with forthright clarity, he outlined his intentions for all to see. He isolated five goals: i) reduce federal taxes and government regulation; ii) balance the federal budget; iii) get tough with our interna-

tional "adversaries"; iv) renew our national pride; and v) return power to the states.

One way of determining how the program of President Reagan would impact state and local government is to examine his budget requests particularly his first budget (fiscal year 1982-October 1, 1981 to September 30, 1982).

Consider his campaign promise to cut taxes and to free the private sector of the burden of excessive government regulation. This promise became one of the twin capstones of his budget requests for fiscal year 1982. Enjoying the benefits of Congressman Jack Kemp's (R-NY) popular proposal to slash federal taxes by one third, President Reagan requested a more modest plan which would reduce marginal tax rates by 10 percent each year for three years. This plan was intended to reduce the bracket rates which ranged from 14 percent to 70 percent to a range of 10 percent to 50 percent.⁶ Congress gave President Reagan nearly all that he requested by cutting marginal tax rates by 25 percent over a 2 1/2 year period so that the bracket rate ranged from a low of 11 percent to a high of 50 percent. In the first year this reduced personal income tax collections by \$44.2B. This tax cut was coupled with a \$9.7B reduction in business taxes which primarily took the form of accelerated depreciation allowances.

In a like manner, Congress obliged the President by honoring his deregulation requests. It moved forward toward the deregulation of natural gas; the elimination of the Department of Energy; the reduction in the budgets of the Justice Department's Anti-trust Division, the Occupational Safety and Health Administrative (OSHA), the Environmental Protection Agency (EPA), the Equal Employment Opportunity Commission (EEOC), and the consumer Product Safety Commission (CPSC); and most blatantly by confirming the appointment of James Watt as Secretary of the Interior over the outcries of many environmentalists.

The remaining capstone of the Reagan program focussed on balancing the Federal budget. Success in this area depended upon the Administration's ability to induce Congress to make major cuts in domestic spending programs and the inauguration of the "supply side stimulus" which was assumed to be associated with reducing marginal tax rates and freeing the business community from the burden of government regulation.

The Reagan Plan did not call for an immediate balance in the Federal budget. Rather it was intended to bring the budget into balance over a three year cycle. He proposed a deficit of \$48.6B in fiscal 1982, \$23B in fiscal 1983 and then a balanced budget in fiscal 1984. Of course this was not to come to pass. The gross federal debt mushroomed from \$928.4B in December 1980 to \$1027.2B in December 1981, \$1195.6B in December 1982, \$1408.6B in December 1983, and \$1660.4B in December 1984.⁷

His fiscal 1982 budget called for a \$48.6B reduction in the expenditure outlays of a constant service level budget.⁸ These budget cuts directly and indirectly impacted state and local governments. The most obvious direct impact was the proposed \$11.6B reduction in grants to state and local governments - a topic which will be discussed later in some detail. But in

addition to this \$11.6B reduction, there were proposed cuts in social security (\$3.0B), food stamps (\$2.3B), trade adjustment assistance (\$1.2B), programs concerning natural resources and the environment (\$1.8B), energy programs (\$3.9B), transportation programs (\$1.7B) and a host of other cuts ranging from veterans' benefits to farm supports.

All of these other budget cuts, with obvious exceptions such as economic aid to foreign countries, impacted state and local governments just as certainly as reductions in Federal grants-in-aid to state and local governments. The Federal government could and did slow the flow of Federal dollars to these programs, but this did not necessarily mean that there was a corresponding reduction in the demand for these program. Indeed, as fall turned to winter in 1981 and the economy began to slide into the most severe recession in the post-depression period, a growing number of individuals, not a declining number of individuals, needed food stamps, trade adjustment assistance and help in paying their utility bills. These individuals turned to their cities, towns and states for assistance. Thus just as Congress began to withdraw from these programs, the beneficiaries began to place larger and larger demands upon these programs. This immediately resulted in a sharp increase in the expenditure responsibilities of state and local governments.

There is a curious irony here. The Reagan policies were designed to reduce Federal support for a number of domestic social programs. However, because Reagan's macro-economics policies threw the economy into a severe recession, Federal expenditures for these domestic social programs actually increased. Take care not to be misled by these aggregate figures. Although total Federal expenditures increased, the Federal share fell. Of course this means that the state and local share of the fiscal burden of these programs increased dramatically.

The impact of the Reagan policies on state and local governments was captured in Tables V and VI. States were forced to increase markedly their taxes, particularly their broad based taxes. But the round of tax increases that occurred in 1981, 1982 and 1983 may be only child's play compared to what may happen in the second half of the 1980s. This depends upon two factors: i) whether or not the Reagan Administration can bring the economy to some reasonable state of full employment; and ii) whether or not Congress continues to implement Reagan's request for cuts in domestic expenditure programs.

The first factor concerning the future state of the economy, of course, is the hardest to forecast. It is evident that many of the economic problems that plague the Reagan Administration - particularly the persistent budget deficits - can be traced to sluggish economic growth. Although the economy burst forth from the 1981-1982 Reagan recession with very high rates of real economic growth, since mid 1984, growth rates have been disappointing and perhaps even alarming. The fact is that industrial production has been virtually unchanged since the second quarter of 1984.⁹ Perhaps if the U.S. dollar continues to weaken, the price of oil continues to fall and consumers continue to be

unpredictably optimistic, the economy may show signs of renewed vigor and in the process take some of the fiscal pressure off of state and local governments. Even if the economy finally recovers from the shock of Reaganomics, state and local governments must still prepare for yet another round of Federal domestic program cuts.

Consider the implications of the 1985 Reagan budget request. In addition to the cost of living freezes for military and civilian retirement programs and the budget freeze applied to nearly every non-defense program, Reagan asked for deep cuts in entitlement programs such as student aid, veteran's health care, farm supports, etc.: the termination of 25 major programs such as General Revenue Sharing, Mass Transit Grants and Urban Development Action Grants; and selective program cuts which include a 10 percent cut in Community Development Block Grants, 10 percent cut in energy research and development and a 40 percent cut in soil conservation programs. Each and every one of these cuts will put added pressure on state and local governments to pick up the expenditure responsibility. If they do incur this responsibility they must by definition increase their taxes.

1984 As a Precursor of the Future

Calendar year 1984 is a pivotal year for state and local governments. First it became clear to state and local officials that the economic momentum which carried the economy along at very high growth rates following the Reagan recession - was markedly fading.¹⁰ This slower growth rate, coupled with the fact that unemployment rates remained high and plant utilization ratio remained low, mean that the tax base and therefore tax receipts would not continue to expand at a rapid rate in the immediate future. But more importantly, it became apparent that Reagan's "New, New Federalism" had come into existence even though Congress had rejected all explicit Presidential initiatives in this area.

President Reagan in his Inaugural Address promised to "return power to the states." This promise was reiterated and articulated in his 1982 State of the Union Message. In this address to Congress and the nation, Reagan stressed his commitment to decentralize government by returning authority to state and local governments. This would have been accomplished in two major steps: i) the Federal government would assume the full cost of Medicaid in return for state governments assuming the full cost of Aid to Families with Dependent Children; and ii) the Federal government would turn over to state governments the fiscal responsibility of forty Federal programs in education, community development, transportation and social services - funds for these programs would be obtained from a temporary trust fund backed by federal excise taxes on alcohol, tobacco, telephones and motor fuels (after five years the trust fund would be dissolved and states would have to raise their own tax receipts to pay for these forty programs).

Reagan's plan for decentralization, which has become known as the New, New Federalism to differentiate it from Nixon's New

Federalism of the late 1960's, was rejected out of hand by Congress. Yet, as a result of the massive cuts in domestic spending programs - particularly cuts in Federal grants-in-aid to state and local governments - fiscal responsibility began to tilt toward state and local governments. Indeed, Federal grants as a percent of state and local own revenue fell from 31.7% in 1980 to 23.7% in 1984 and are expected to fall to levels that have not been experienced since the great Society days of the mid 1960's.¹¹

At the same time that the Federal government was withdrawing from participating in state and local expenditure programs, state governments began to withdraw from participating in purely local expenditure programs. Total state aid as a percentage of local government revenue fell from 63.6% of local budgets in 1980 to 55.6% in 1983. Thus as Table VII indicates, there has been a radical shift in the nature of our fiscal federalism. Local governments, particularly county and city governments, are far more dependent on their own sources of revenue in 1980 than they have been in recent memory. The relative importance of grants-in-aid for county governments has fallen by more than 21% while the relative importance of grants-in-aid for city governments has fallen by nearly 26%. By definition this means that these local governments must be more dependent on their own sources of revenue which for the most part is the property tax.

Thus we have come full circle. In 1978, the tax revolt was first excited by high property taxes in California. In 1985, there is every indication that across the country, property taxes are on the rise again. Property taxes as a percent of total state and local taxes were 30.7% in 1981, 30.8% in 1982 and 31.4% in 1983.¹² Given the decline in Federal and state aid to local governments the importance of property taxes must continue to increase in our system of fiscal federalism.

But in 1985 there are new consequences associated with this rise in property taxes. This rise in property taxes is the direct result of decentralization and not all local governments are fiscally capable of financing this decentralization. That is, some local governments in both the "frost belt" where the tax base is declining at least in relative terms because of the out migration of industrial concerns and in the "sun belt" where immense pressure is applied to the tax base as the new entrants demand basic infrastructure, simply can not afford basic government services. In the past, Federal and state grants-in-aid offset in part these differences in fiscal capacity. Now these differences will be exaggerated rather than moderated. That is, those localities with the lowest fiscal capacity face a double jeopardy: their grants-in-aid have been cut; but more importantly perhaps, social program cuts will effect them disproportionately since the recipients of these programs are more likely to reside in these low capacity localities.

Some indication of the fiscal stress that we are imposing upon certain states in both the frost belt and the sun belt is seen in Table VIII. Consider the case of Rhode Island in the frost belt. It's tax capacity compared to other states is slowly eroding from a position which is well below the nation's average.

While at the same time its tax effort is slowly growing from a level which is well above the national average. It must be remembered that states experiencing fiscal stress are not limited to the frost belt. States in the Southeast, Rocky Mountain region and the Far West are also experiencing a decrease in their tax capacity and an increase in their tax effort.

However, the fiscal stress which is evident in Table VIII hides the extent of stress in our system of Fiscal Federalism. As Table VII implied, the real losers in the system are our city and county governments. Here the variation in fiscal capacity and fiscal effort is an immediately pressing concern. Here the real cost of President Reagan's New, New Federalism is borne.

Table VII

Federal and State Aid* Per \$1.00 of Local General Revenue

Units of Government	1962	1975	1978	1980	1981	1982	1983	Change 1978-83
All Local Government	\$0.44	\$0.73	\$0.76	\$0.79	\$0.76	\$0.71	\$0.67	-11.8%
Counties	0.60	0.78	0.80	0.81	0.77	0.70	0.63	-21.2%
Cities	0.26	0.63	0.62	0.56	0.53	0.50	0.46	-25.8%
Townships	0.28	0.40	0.41	0.39	0.40	0.41	0.40	-2.4%
School Districts	0.65	0.94	1.01	1.25	1.23	1.15	1.13	+11.9%
Special Districts	0.15	0.42	0.44	0.42	0.47	0.39	0.36	-18.2%

*INTERPRETATION: \$0.44 indicates that for each \$1.00 of local general revenue, 44 cents is transferred from federal and state governments.

Source: Significant Features of Fiscal Federalism, 1984 Edition, (Washington D.C.: U. S. Advisory Commission on Intergovernmental Fiscal Relations, March, 1985).

Table VIII

Tax Effort and Tax Capacity of Selected States
1979-1982*

State	1979		1980		1981		1982	
	Effort	Capacity	Effort	Capacity	Effort	Capacity	Effort	Capacity
Rhode Island	121	84	123	84	130	80	133	81
Pennsylvania	105	93	104	93	105	90	106	89
Illinois	99	112	102	108	105	104	107	99
Michigan	113	104	116	97	116	96	120	93
Oregon	93	106	93	103	101	99	95	99
Kentucky	87	85	89	83	88	82	88	82
South Carolina	91	76	95	75	95	75	96	74
Montana	88	113	92	112	92	114	97	110

*100 is the index for the U. S. Average.

Source: Significant Features of Fiscal Federalism, 1984 Edition, (Washington D.C.: U. S. Advisory Commission on Intergovernmental Fiscal Relations, March, 1985).

The crisis is not limited to large metropolitan communities that are recognized to be high tax areas. Although it is likely that there is little fiscal flexibility in cities such as Detroit, Milwaukee, Philadelphia and New York where the burden of state and local taxes on a family earning \$25,000 per year can exceed 10%,¹³ there are numerous mid-sized and small cities which are also fiscally inflexible positions.

What is the prognosis for these cities? Are we willing to stand by and watch these cities reach some critical point where one more tax increase or one more service reduction drives the last of the middle income taxpayers from the tax jurisdiction? That is, are we willing to subject our urban centers to some vague notion of market competition where the weak are weeded out of existence and the strong prosper? Will this be the legacy of Proposition 13?

ENDNOTES

1. See Tables III and IV.

2. Motor fuel taxes are of particular interest in this situation. The large number of tax increases here can be traced to two factors. First, states rushed to convert their excise tax from a per unit tax to an ad valorem tax. Their expectation of course, was that motor fuels would continue to rise in price and with those price increases so would tax receipts. Unfortunately, gasoline prices did not go to the \$2.00 or \$3.00 per gallon price as many predicted, rather the price fell in both real and nominal terms. Second, legislatures could treat this tax as a user charge. This type of user charge was completely consistent with the rhetoric of the politically popular Reagan Administration.

3. Jimmy Carter, The Budget of the United States Governments Fiscal Year 1980, p. 3 (emphasis added).

4. Walter Heller, et al, Revenue Sharing and Its Alternatives: What Future for Fiscal Federalism? (Washington D.C.: U.S. Government Printing Office, 1967).

5. It should be noted that the distribution formula was also modified along the way. Originally, the formula specified that one third of the funds would stay with state governments and two thirds would be passed on to local governments. Of course this was changed in the 1980 legislation. Additionally, the original formula which allocated funds on the basis of population adjusted for income and tax effort differentials, was modified to also include an adjustment for urbanized population and state income tax collections. The urban adjustment was in recognition of the unique fiscal problems for these areas, while the state income tax adjustment was an attempt to induce states into adopting state income taxes. The logic was that as more and more states adopted an income elastic tax base, and the federal government

could get out of the general revenue sharing game.

6. In reality this tax cut proposal, which received extensive media attention, remained largely misunderstood by the tax paying community. The tax cut proposal was widely perceived to represent a 30 percent reduction in personal income tax liability, in fact it represented a 30 percent reduction in the tax rates. This rate reduction would provide a more substantial tax savings to high income families than it would for low income families and a far smaller tax reduction for everyone compared to a 30 percent across the board reduction in tax liability.

7. These budget deficits are stated in current terms. If they were corrected for inflation, the magnitude of the deficits would appear somewhat smaller in the 1970s as inflation raged through the economy and somewhat larger in the 1980s as inflationary pressures receded.

8. Some account had to be taken of inflation which was present in double digit levels. Since the annual inflation rate was approximately 10 percent in 1981, dollar expenditures had to be increased by 10 percent if service levels were to be maintained. As a consequence of these inflationary pressures, the Reagan budget called for an increased level of government spending in constant dollar terms.

9. National Economic Trends, The Federal Reserve Bank of St. Louis. (June, 1985) p. 7.

10. As the economy began to recover from the depths of the Reagan recession (depression) it grew at a 7.10% real growth rate. By the second quarter of 1984, this initial burst of economic activity was spent and the economy began to grow at a slower pace: 1.6% in the second quarter, 4.2% in the third quarter .03% in the fourth quarter, and 1.7% in the first quarter of 1985. The average real growth rate was a modest 1.9%.

See: National Economic Trends, The Federal Reserve Bank of St. Louis (July, 1985) p. 13.

11. Federal grants-in-aid are estimated to account for only 21.4% of state and local governmental receipts in fiscal year 1986. This low level of federal participation in the finance of state and local programs has not occurred since fiscal year 1967.

See: Significant Features of Fiscal Federalism, 1984 Edition, (Washington, D.C.: U.S. Advisory Commission on Intergovernmental Relations, March, 1985), Table 8, p. 21.

12. Significant Features of Fiscal Federalism, 1984 Edition, (Washington D.C.: U. S. Advisory Commission on Intergovernmental Fiscal Relations, March, 1985) Table 40, p. 60.

13. Significant Features of Fiscal Federalism, 1984 Edition,
(Washington D.C.: U. S. Advisory Commission on Intergovernmental
Fiscal Relations, March, 1985) Table 78, p. 129.