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State and Local Red Ink: Crisis or Opportunity?

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The 1980s saw a significant restructuring in the roles of state and local governments within our federal system. Whereas the 1960s and 1970s witnessed a dramatic increase in federal aid and a corresponding expansion of federal scope and responsibility for providing local public services, this trend reversed during the 1980s in response to federal budgetary stress and to the change in political philosophy that resulted in the election of President Reagan. State and local governments, which had expanded their own spending in response to the availability of federal aid, were forced to either scale back services or raise their own revenues to provide for them.

This restructuring has not been accomplished without political and fiscal stress. With no federal safety net, state and local governments are more vulnerable to economic fluctuations. Despite the sustained national economic expansion of the past decade, a growing number of state governments have reported red ink as a result of regional slowdowns. Dependent on their own resources, state and local governments have had to rely on "rainy day" funds to respond to unexpected regional developments. Those that inadequately prepared for economic surprises are now suffering the consequences—witness Massachusetts.

This *Economic Commentary* reviews the current fiscal stress in the state and local sector, links this stress to the changing role of the federal government, and discusses the costs and benefits of restructuring. There are strong arguments for the idea that the federal government can, through support of the state and local sector, enhance economic efficiency and provide for greater equity in our society. The record of federal programs in achieving these goals, however, is mixed. Often, federal funding is unrelated to real state- and local-level needs.

On the other hand, some analysts believe that reduced federal dollars in state and local government coffers will result in a more efficient public sector with no sacrifice in equity. They argue that federal aid can distort the cost of government expenditures as perceived by state and local governments, leading to higher levels of spending. Cutbacks force state and local decisionmakers to weigh the costs and benefits of public expenditures more accurately and, through that process, to better reflect the preferences of their constituents.

Have the Reagan-era cutbacks in federal aid to state and local governments resulted in decreased economic efficiency and social equity, or have they had just the opposite effect, as some economic analysts would argue?

■ Overview of Fiscal Health

The aggregate surplus of state and local governments, a commonly cited indicator of fiscal well-being reported in the National Income and Product Accounts (NIPA), provides little cause for concern about the fiscal health of those governments (table 1). The state and local sector has consistently shown a surplus throughout the 1980s, ranging from $26.8 billion in 1980 to a peak of $65.1 billion in 1985, and standing at $44.3 billion in 1989.

The NIPA accounts, however, mask two important considerations: (1) the inclusion in the surplus of net contributions to social insurance funds, which do not finance current operating expenses, and (2) the considerable variation in fiscal conditions across states and localities.

Excluding net contributions to social insurance funds from the aggregate figures substantially alters the picture. The most recent NIPA estimates show an operating shortfall of $33 billion in 1989, which marks the third consecutive year of mounting red ink.

In many respects, a state or local government deficit is more alarming than a federal one of equal proportion, because most state and local governments are required by law to balance their budgets. Consequently, they must operate more like a business or

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household, typically setting aside a rainy day fund and trying to maintain a budget surplus of at least 5 percent of expenditures. If a deficit persists, the state or local government could go into a form of bankruptcy.

The latest survey of state budget officers projects total year-end balances to be only $8.3 billion, or 3.0 percent of expenditures in 1990, a $4.3 billion drop from 1989. Of these ending balances, general funds account for $5.7 billion, while rainy day funds account for $2.5 billion. Although more than half of the states (29) ended fiscal year (FY) 1989 with balances of more than 5 percent of expenditures, it is estimated that the number of states in this category will decline to 20 in FY 1990. By the end of FY 1991, 39 states will hold less than 5 percent of expenditures, and 12 will hold balances of less than 1 percent.[1]

Nationwide, 30 states and the District of Columbia passed tax measures that increased net revenues by $4.9 billion in FY 1990. Twenty states have reduced or proposed to reduce enacted 1990 budgets by a total of $2.6 billion. For FY 1991, an additional $4.9 billion in revenues from new taxes has been proposed. More than 50 percent of the recommended increase is accounted for by just two states, New Jersey and New York.

Budgetary conditions vary significantly across states and regions in response to regional economic fluctuations and surprises. For example, in the Northeast, state governments that projected continued high levels of growth in incomes are experiencing a shortfall in revenues due to a regional slowdown. While Hurricane Hugo had a negative effect on the South Carolina government, the employment of cleanup crews for the Exxon oil spill had a positive effect on Alaska's budget.[2]

■ The Changing Federal Role

The decade of the 1960s was a boom period for the national economy, as well as for state and local governments. A "golden age" of federal assistance began in 1964 with programs such as the Economic Opportunity Act, Medicaid, the Elementary and Secondary Education Act, the Manpower Training and Development Act, the Comprehensive Employment and Training Act, Community Development Block Grants, the Law Enforcement Assistance Administration, and the Economic Development Administration.

This expansion of federal largesse culminated in October 1972 with the signing of the "State and Local Fiscal Assistance Act," popularly known as general revenue sharing, which provided unearmarked federal funds for local expenditures. As shown in table 2 and figure 1, state and local revenues and expenditures grew as a result of the expansion in federal aid, reaching a peak in the mid-1970s. By 1978, state and local revenues had reached 14.9 percent of GNP, an increase of 5.4 percentage points from 1960, with federal grants contributing 2.2 percentage points of this increase. At its peak, federal aid comprised 26.5 percent of state and local expenditures, an increase of 444 percent in real terms from the 1960 level.

Unlike the previous two decades, the 1980s were a period of slow growth in the state and local sector. State and local spending, which had grown at a 4.4 percent annual rate between 1960 and 1978, slowed to a 2.7 percent growth rate and was flat as a percentage of GNP. This turnaround was initiated in part by the Proposition 13 tax revolt in California, which sparked other state and local governments to implement a series of controls on taxes and expenditures. More important, however, the change resulted from a dramatic reversal in the federal role in financing state and local governments.

Receipts of state and local governments from their own tax sources, which had been steadily rising as a share of GNP, changed little during the 1980s. As shown in figure 2, a decrease in property tax revenues was offset by increases in sales, income, and other tax revenues. But while state and local tax revenues remained stagnant, a major reversal in federal assistance occurred. By the end of the decade, federal aid declined by 16 percent in real terms from the 1978 peak. Federal grants as a share of GNP fell from 3.6 percent in 1978 to 2.3 percent in 1989, a one-third decline. The net result was a 0.6 percent decrease in state and local revenues as a share of GNP. To put the decline into perspective, 1.1 percentage points as a share of GNP represented $58 billion in the $5,233 billion 1989 economy. This more than accounts for the current operating deficit of $33 billion mentioned above.

The traditional roles of state and local governments suffered the largest cutbacks in federal support. Assistance for general government purposes—for example, police, fire protection, parks, and libraries—fell by more than 50 percent as a share of GNP, being replaced by payments to individuals through programs such as Medicaid, which are administered by state and local governments. By 1989, these payments had expanded to comprise more than half of all federal dollars taken in. Federal assistance for capital investments remained stable over the period in real terms.

The Bush Administration's proposed budget for FY 1991 continues this trend. Federal payments to individuals via state and local governments are projected to continue to rise in real terms (eventually comprising 65 percent of federal assistance in 1995). Funds for general government will remain unchanged, while aid for capital investment is projected to decline.

■ The Case for Federal Assistance

Traditional arguments for a federal role in providing state and local services involve both equity and efficiency considerations. Citing equity grounds, a federal government can redistribute resources from wealthy states to poor areas. Federal funding of education, for example, is often justified by its proponents as necessary to level wide disparities in educational spending across the nation. Similar arguments are made for federal involvement in health and welfare programs.

TABLE 1 AGGREGATE STATE AND LOCAL SURPLUS/DEFICIT (Billions of dollars)

Year	Total	Social Insurance Contributions	Operating Budget
1980	26.8	27.1	-0.3
1981	34.1	30.0	4.1
1982	35.1	36.9	-1.7
1983	47.5	43.1	4.4
1984	64.6	44.8	19.8
1985	65.1	51.3	13.8
1986	62.8	57.2	5.6
1987	51.3	63.7	-12.4
1988	49.7	71.1	-21.4
1989	44.3	78.0	-33.8

SOURCE: National Income and and Product Accounts.

TABLE 2 STATE AND LOCAL REVENUES (Percent of GNP)

Year	Total	Sales Tax	Property Tax	Income Tax	Other Taxes	Social Insurance	Federal Aid
1960	9.5	2.3	3.0	0.5	1.5	0.6	1.4
1965	10.8	2.5	3.3	0.6	1.7	0.7	1.6
1970	13.0	3.1	3.5	1.1	1.8	0.9	2.4
1975	14.7	3.3	3.3	1.4	2.1	1.0	3.3
1978[a]	14.9	3.2	3.0	1.6	2.1	1.1	3.6
1980	14.3	3.0	2.5	1.6	2.3	1.1	3.4
1985	14.5	3.3	2.7	1.8	2.7	1.1	2.7
1989	14.3	3.3	2.7	1.8	2.6	1.1	2.3

a. Peak.
SOURCE: Authors' calculations.

FIGURE 1 CHANGE IN STATE AND LOCAL REVENUES, 1960-78

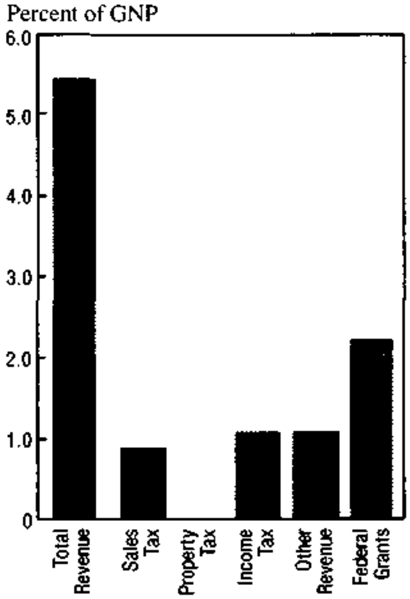
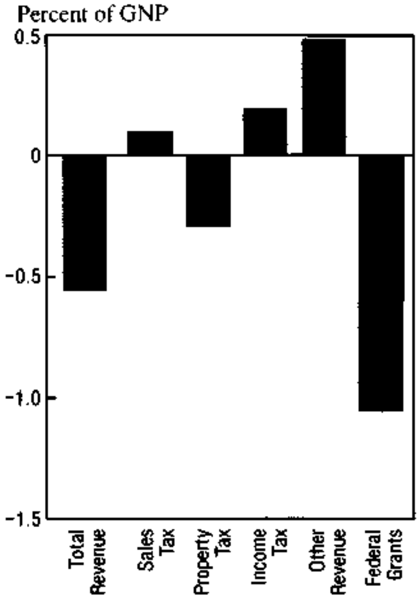


FIGURE 2 CHANGE IN STATE AND LOCAL REVENUES, 1978-89



SOURCE: Authors' calculations.

Some analysts also contend that areas of the country undergoing transition and economic restructuring merit assistance, through federal funding, from areas experiencing growth, with the better-off areas implicitly insuring themselves against future downturns. It is also argued that the federal revenue system is more progressive than state and local tax instruments, suggesting that federal financing is more desirable on equity grounds.

Efficiency arguments for a major federal role in providing domestic government services emphasize the comparative advantage of the federal government in raising revenues. Tax tools of the federal government (principally the income tax) are perceived to be more efficient than sales and property taxes in terms of minimizing economic distortions. In addition, there may be economies of scale (efficiencies that result from a larger scale of operations) in the administrative structure of the federal government for raising revenues.

Federal assistance can also enhance efficiency because some potential benefits of state and local spending spill over beyond the boundaries of a local jurisdiction. These external benefits, however, might not be perceived by local decisionmakers, leading to an underprovision of the public good. Federal support for increased expenditures can alleviate this underprovision. For example, transportation networks built by state governments benefit travelers and promote commerce nationwide. Examples of such infrastructure built by states with federal assistance include highways, airports, and water-transportation networks.

■ The Case Against Federal Assistance

Several studies argue that, overall, federal aid has not measured up to its potential of enhancing efficiency and equity. Results show that federal aid allocation is not significantly related to any measure of local fiscal capacity or effort. Stein and Hamm examined more than 35,000 municipal governments for the years 1977 and 1982 and found an "absence of a strong or even modest federal effort to redistribute aid monies to the modest and lowest capability communities."[3] State governments, on the other hand, have been shown to target aid more effectively to distressed communities, suggesting that shifting responsibilities from the federal to the state level could potentially enhance equity. Current court-ordered reforms in Kentucky and Texas for equalizing school expenditures across districts point toward the ability of states to address equity considerations.

Another factor to consider is the potential gain in efficiency that results from healthy competition among local governments. Several economists, including two Nobel laureates, contend that competition among the 80,000 U.S. state and local governmental units for citizens/taxpayers acts as a check on bureaucratic inefficiency and government overspending.[4]

It is also argued that federal intervention can reduce the responsiveness of state and local governments by distorting the costs and benefits of public services. Both matching and unconditional federal grants act to create an oversupply of public goods and, by shielding taxpayers from the true costs of public services, dilute the efficiency of competitive federalism.

Empirical evidence suggests that increased federal aid reduces the variation in level of public expenditures across states but increases the overall level of such expenditures.

■ Conclusion

The current fiscal crisis facing state and local governments has forced those governments to make some tough choices between raising revenues or cutting expenditures. The hard-line stance taken by the federal government against raising general revenue taxes has been compensated for by tax increases at the local level. Still, less reliance on the federal trough may have long-term benefits. For example, state and local governments now face the true cost of providing public services and must weigh the costs and benefits of public expenditures through politically challenging budget processes.

A result of this transition is likely to be greater variation in public services that more accurately reflect the preferences of local citizens. To the extent that federal aid was never effectively targeted toward distressed areas, and that state-level programs can incorporate redistributive elements, the overall equity of our federal system can be preserved while efficiency is enhanced.

■ Footnotes

1. See Marcia A. Howard, *Fiscal Survey of the States*, Washington, D.C.: National Governors' Association and National Association of State Budget Officers, March 1990.

2. See *State Budget & Tax News*, vol. 9, no. 5 (March 8, 1990), p. 11.

3. See Robert M. Stein and Keith E. Hamm, "A Comparative Analysis of the Targeting Capacity of State and Federal Intergovernmental Aid Allocations," *Social Science Quarterly*, vol. 68 (September 1987), pp. 447-65. A discussion of this article and other targeting studies, and a general review of fiscal federalism, appear in Thomas R. Dye, *American Federalism: Competition Among Governments*, Lexington, Mass.: Lexington Books, 1990.

4. See James M. Buchanan, "Why Does Government Grow?" and other articles in Thomas E. Borcherding, ed., *Budgets and Bureaucrats: The Sources of Government Growth*, Durham, N.C.: Duke University Press, 1977. Also see Milton Friedman, *Free to Choose*, New York: Harcourt Brace Jovanovich, 1980.

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