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Middle-of-the-Road Federalism

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November 9-11
Chicago
(see pages 4-5)

Many recent political debates have revolved around the question of whether our intergovernmental system should move toward the state-dominant or the Washington-dominant extremes that have characterized most of our history. Little noticed is that we have already evolved toward a balanced intergovernmental system that differs sharply from both extremes. Barring sudden crisis, the nation is likely to remain in this relatively new stage of federalism for some time to come.

State-Dominant Federalism (1789-1933)

The first stage of federalism began the day George Washington took office in 1789 and ended with Franklin Roosevelt's first inauguration in 1933. This was small-government federalism, based on Thomas Jefferson's philosophy that the best government is the least government. It was built on widespread faith in self-reliant individuals nurtured by private institutions, including the family, the church, and the market. This brand of federalism was sustained for 140 years by a narrow judicial and political interpretation of federal domestic power. The shared presumption was that the states and their localities had sufficient regulatory and fiscal power to meet the nation's modest domestic demands except in well-defined and limited circumstances. A minimalist federal domestic presence, a modest state-local sector, and a virtually unfettered marketplace characterized fend-for-yourself federalism whose spirit was captured by Calvin Coolidge's's observation that "the business of America is business." Though the Civil War and World War I sent revenue and regulatory powers from the states to Washington, the pendulum swung back and the relative balance of power returned to the states and their localities.

Washington-Dominant Federalism (1933-late 1970s)

Washington replaced the states as the dominant partner in American Federalism between the New Deal in 1933 and the late 1970s. This period saw explosive growth in the national government and relative contraction of both the private and state-local sectors' shares of the economy. A centralizing supercrisis—the Great Depression of the 1930s—dealt what had been a highly stable federal system a transforming blow. Radicalized by unprecedented unemployment, mass foreclosure of homes and farms, and widespread bank failures, badly shaken middle class voters turned to the national government for extraordinary help.

Before the federal government could extend such assistance, it had to cut the constraints created by the time-honored but narrow interpretation of its constitutional powers. It replaced those constraints with the New Deal, an empowering formula based on a very broad interpretation of federal constitutional power. Washington had always emerged as the dominant intergovernmental partner during major wars; now, for the first time, it assumed that same role in peacetime.

Hardly had the Supreme Court signaled its grudging approval of the New Deal when a second crisis struck the nation in the form of World War II, and in its wake the Cold War and the Korean War. These centralizing events reinforced the permanence of the shift from state- to Washington-dominant federalism that had come about from combating the Depression. World War II and the Korean War massively strengthened the fiscal and regulatory hands of the federal government. In this stage of federalism, power remained in Washington even after the national crisis had passed.

In retrospect, the four decades following the Great Depression stand out as the golden era of federal finance. A steady flow of new money was available to accommodate the needs of

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a wide range of groups. Liberals got their new social welfare programs, conservatives their periodic tax cuts, governors and mayors steady real increases in federal financial assistance. Specifically, the federal government waged a war on poverty, created Medicare and Medicaid, launched the Interstate highway and environmental protection programs, and increased federal aid programs to states and localities.

The Current Era: A More Balanced Federal System

In the 1980s, slow economic growth and a burgeoning federal budget deficit born of excessive borrowing led to the end of Washington-based federalism and to the present stage, which I call middle-of-the-road federalism. The most striking feature of the new era is this: For the first time in American history, neither the states nor the federal government dominate the intergovernmental landscape. The states have lost their privileged constitutional status and the federal government its crisis-bestowed fiscal and public confidence advantages.

Today, our sprawling and complex intergovernmental system is slowly being reshaped by the growing discipline of fiscal constraints, the incrementalism of middle class politics, and the logic of comparative advantage.

Only the federal government with its continent-wide jurisdictional reach can create a national safety net for the poor, underwrite social insurance protection for the middle class, and set the general rules of the game in such critical areas as interstate commerce, civil rights, environmental protection, telecommunications, and health care financing.

At the same time, because of their closeness to the people, the 50 states and their 85,000 local governments are in a far better position than Washington to fit the pain of taxation to the benefits of most domestic public services. Why? These jurisdictions are marked by widely varying tastes for public services and willingness to pay for them. Also, because of their limited jurisdictional reach, states and localities are forced to operate in a fiscally disciplined and economically competitive environment. To paraphrase the father of the Constitution, James Madison, if the states and their thousands of local governments did not exist, we would have to create them.

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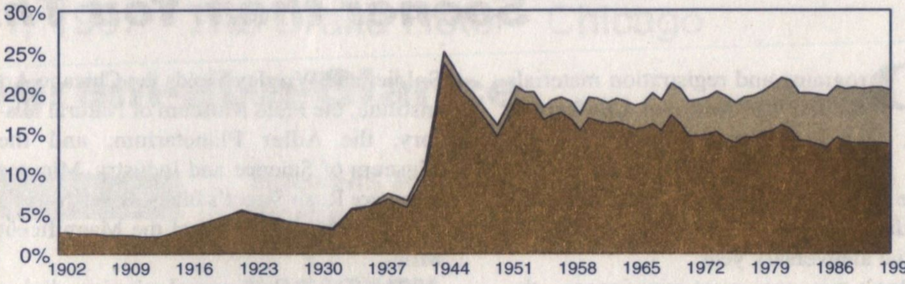
The growing fiscal squeeze is forcing creeping devolution at the federal level and creeping privatization at all three levels of government. As we approach the 21st century, the public sector is relying more and more on user charges, such as new and increased highway tolls, recreational fees, and state university tuition payments, to ration and finance its programs. The government is contracting increasingly with private firms to administer public services, such as trash collection, security protection, and even welfare administration. And tax financing is being used to purchase private goods and services. Examples include food stamps, public housing vouchers issued to low-income families for use in the open housing market, the Department of Veterans Affairs contracting with private nursing homes to care for aging veterans, and educational vouchers to foster school choice (being introduced in some parts of the country).

Why Federalism is Taking the Middle Road

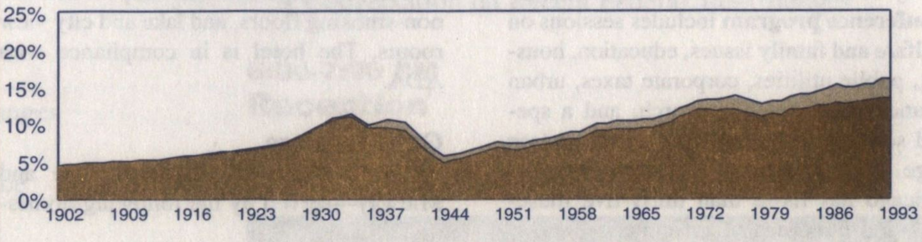
Our intergovernmental system appears to be locked into this most recent stage of its evolution—middle-of-the-road federalism—for four reasons.

First, there is no possibility that the middle class political pendulum will swing to the far right and carry the nation back to the first stage of federalism. Small-government federalism was characterized by one stunning fiscal fact that cannot be replicated today: as late as 1927, total federal, state, and local spending constituted only 9 percent of Gross Domestic Product (GDP)—a figure representing about one-fourth of current public spending. Today's middle class, whose needs drive politics, now relies on costly and highly regarded federal benefits like Social Security, Medicare, and college loans and grants. Equally important, though little noticed, today's middle class depends heavily on a state-local sector that has become a big government. If social insurance contributions are omitted, the state-local sector now collects almost as much general government revenue as the national government—13.4 percent versus 13.6 percent, respectively (see figure). In the world of fiscal federalism, quantitative changes have had qualitative, long-lasting effects. The American intergovernmental system may be devolving more power to states and localities, but it can't go home again to small government.

Federal Government Revenue as Percentage of GDP, 1902-1993*



State and Local Government Revenue as Percentage of GDP, 1902-1993**



■ General Own-Source Revenue ■ Social Insurance Contributions

Source: C. Eugene Steuerle and Gordon Mermin, the Urban Institute.
**Excluding postal revenue.
**Excluding federal grants to state and local governments and utility and liquor store revenue.

Second, absent a galvanizing and centralizing supercrisis, the middle class pendulum will not likely swing to the far left and carry the nation back to Washington-dominant federalism. Liberal, big-government federalism was premised on extraordinary confidence in the problem-solving ability of the federal government. This level of confidence does not exist today. Perhaps more important, so far in this current stage we have not faced the kind of national crises that characterized the Great Depression or World War II eras.

Third, today's centrist brand of federalism is driven by the "been there, done that" spirit of the times and shaped by a cautious middle class that is deeply distrustful of extremists, be they of the left or right. The same middle class message was recently delivered to both liberal health care reformers and conservative "revolutionaries"—*keep the ball in the center of the field.* By shifting support back and forth between conservative and liberal policymakers, middle class voters keep striking new balances between competing demands for more private economic growth and more social welfare.

Fourth, the current United States Supreme Court is also following in the steps of federalism's ultimate moderator—middle class voters. Slowly and deliberately, the Court is now reversing its long-held centralizing course. Often in closely divided opinions, the Court majority is placing certain limits on the power of the Congress to impose its regulations on states and their localities. There is virtually no likelihood, however, that the High Court's renewed concern for states' rights will carry it to the other extreme by declaring unconstitutional the New Deal/Great Society social welfare legislation. As in the case of the Congress and the Presidency, the Supreme Court is now steering a course back toward the center of federalism's power spectrum. How? By rejecting congressional actions calling for greater centralization of regulatory power, the Court has shored up the badly eroded constitutional position of the states. However, by showing no disposition to jettison the national regulatory framework of the last 60 years, the national government is left with strong—but no longer *virtually unlimited*—powers in relation to the states.

The larger message is that after 200 years the federal and state-local sectors are likely to be forced into a true partnership because neither sector will be able to dominate the domestic front.

In 20 years, centrist federalism may look very different from the way it looks today. The rationing of functions among the national, state, and local levels may sort out in different ways due to changing demographics. Nonetheless, it seems likely that in the absence of national crises the middle class will ensure that any shifts in distribution of powers will take place incrementally and, to continue the football image, between the 40-yard markers.

As Aristotle has said, "In every city the people are divided into three sorts: The very rich, the very poor, and those who are between them. . . . The most perfect political community must be amongst those who are in the middle rank." If implemented carefully and well, this centrist brand of federalism might even, if we are lucky, qualify for the golden mean award—the Aristotelian seal of good government.

***NOTE:** This article first appeared in The Urban Institute newsletter* The Future of the Public Sector, *Number 10, February 1997. The author has added some material for this version.*

NTA in CHICAGO
Sooner than You Think!

Programs and registration materials for the **90th National Conference on Taxation** will be sent to members around Labor Day. Program Chair Dave Sjoquist has put together an outstanding Annual Conference for this very special anniversary year.

Don't miss two great experiences—the Conference and the city of Chicago! There really is something for everyone. **The Conference program** includes sessions on welfare and family issues, education, housing, public utilities, corporate taxes, urban finance, government research, and a special session on the Midwestern states (see page 5 for the "Program-at-a-Glance"). Chicago has more than thirty-five museums and hundreds of art galleries, sports teams of all kinds, a dozen shopping centers and specialty shops galore, and a wide variety of restaurants for every taste.

Come and see the special blend of Chicago life, where turn-of-the-century landmarks stand shoulder to shoulder with tomorrow's premier architecture. The skyscraper was born in Chicago, and three of the world's tallest grace the skyline. Downtown Chicago is also an outdoor sculpture museum.

Of course, Chicago is music—jazz, gospel, blues, symphonic, opera and folk music in a variety of settings throughout the city. There also are over 100 theater companies.

The city boasts 29 miles of lakefront shoreline, over 7,000 acres of parks, two conservatories, and the zoo.

The Conference Hotel

The Drake has been a symbol of elegance in Chicago for 75 years. It is located in the heart of the Gold Coast, overlooking Lake Michigan on the "Magnificent Mile" in the center of the city's shopping, nightlife, culture, and dining.

The NTA Conference rate will be $135 (plus 14.9 percent tax) for single and double rooms. The reservation number is 1-800-55-DRAKE.

Opposite the hotel is the Oak Street Beach, with a marked 18-mile jogging and cycling trail. Within easy access are the business centers of the Merchandise Mart and McCormick Place, sporting events at Soldier and Wrigley Fields the Chicago Art Institute, the Field Museum of Natural History, the Adler Planetarium, and the Museum of Science and Industry. Minutes away are Rush Street's blues, River North's jazz, and the boutiques of the Magnificent Mile.

The Drake has award-winning dining facilities, a fully staffed business center, an exercise room, and several shops. There are non-smoking floors, and lake and city view rooms. The hotel is in compliance with ADA.

Getting There

Chicago has two airports—O'Hare and Midway—served by the following domestic airlines:

Air Canada (1-800-776-3000)
America West (1-800-235-9292)
American Airlines (1-800-433-7300)
Frontier Airlines (1-800-432-1359)
Northwest Airlines (1-800-225-2525)
Southwest Airlines (1-800-435-9792)
United Airlines (1-800-241-6522)
US AIRWAYS (1-800-428-4322)
Western Pacific (1-800-930-3030)

Continental Airport Express Van Service (312-454-7799):

O'Hare–Vans depart as frequently as every 5 minutes. Fare is $14.75 one way/$25.50 round-trip. Ticket counters are opposite the baggage claim areas.

Midway–Vans depart every 15-20 minutes. Fare is $10.50 one way/$19 round trip.

Taxi Service:

O'Hare–Taxis are on the lower level of each terminal and run from 6:00 AM to 1:00 AM. Fare is between $25 and $30, and the time is about 30 minutes. A Shared-Ride Program allows visitors to be charged a flat rate of $15.

Midway–Taxis are in front of the main terminal. Fare is between $20 and $23, and the time is about 20 minutes. Shared-Ride rate is $10.

Chicago Transit Authority

O'Hare–CTA trains leave from inside the terminal on the lower level every 5 to 10 minutes day and evening. Fare is $1.50, with free connections, and the time is about 40 minutes.

Midway–CTA trains leave from a station connected to the east side of the airport. Fare is $1.50, with free connections, and the time is about 30 minutes. Trains run from 5:00 AM (7:30 Sunday) to 11:30 PM.

AMTRAK (1-800 USA RAIL) operates as many as 50 trains daily in and out of Chicago's Union Station (210 S. Canal, 312-655-2385).

Karl Scholz Is NTA Luncheon Speaker

John Karl Scholz, Assistant Secretary for Tax Analysis, U.S. Department of the Treasury, will give the Annual Conference luncheon address on Monday, November 10.

While at Treasury, he is on leave from the University of Wisconsin-Madison, where he is an Associate Professor of Public Policy and Economics. He is an associate at the Institute for Research on Poverty, a Faculty Fellow at NBER, and an international affiliate of the Institute for Fiscal Studies in London. He served previously as a Senior Staff Economist at the Council of Economic Advisers, Executive Office of the President.

90th ANNUAL CONFERENCE ON TAXATION

November 9-11, 1997 • The Drake Hotel • Chicago

Program-at-a-Glance

SUNDAY NOVEMBER 9

1:00-3:00 PM
General Session
- ❑ Welfare Reform and State Responses

3:15-4:45 PM
Three Concurrent Sessions
- ❑ The Implications of Demographic Changes
- ❑ New Data, New Analysis
- ❑ A View from the Commissioner's Office

5:00-6:00 PM
Annual Meeting of the National Tax Association/Presidential Address

6:15-7:15 PM
Reception

MONDAY, NOVEMBER 10

8:30-10:00 AM
General Session
- ❑ Corporate Tax Reform

10:15-11:45 AM
Three Concurrent Sessions
- ❑ Education Alternatives
- ❑ Taxation of Public Utilities in an Era of Deregulation
- ❑ Taxation of Multinational Corporations

Luncheon: John Karl Scholz
Deputy Assistant Secretary, Tax Policy Analysis, U.S. Department of the Treasury

1:45-3:15 PM
Three Concurrent Sessions
- ❑ Social Security: Politics, Savings, and Compliance
- ❑ Reengineering the Sales Tax
- ❑ Frontiers of Public Finance: Outstanding Doctoral Dissertation Award Winners

3:30-4:45 PM
Committee Programs

5:00-6:00 PM
Special Session
A Conversation on Recent Federal Tax Changes

6:00-7:00 PM
Reception

TUESDAY, NOVEMBER 11

8:30-10:00 AM
Three Concurrent Sessions
- ❑ Taxation and the Family
- ❑ Recent Revenue Performance and the Economic Conditions of Midwestern States
- ❑ Frontiers in State Revenue Estimating and Forecasting

10:15-11:45 AM
Two Concurrent Sessions
- ❑ The Role of State Taxpayers Associations
- ❑ Innovative Financing Options for Urban Governments

1:45-3:15 PM
Two Concurrent Sessions
- ❑ Taxation of Housing
- ❑ Taxation and the Courts

3:30-4:45 PM
Committee Programs

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Spring Symposium Papers in September *NTJ*

"The Post-Election Agenda: Implementation or Confrontation?" was the theme of the 1997 NTA Spring Symposium. The papers will be published in the September *National Tax Journal*. The contents follows:

Alan J. Auerbach, "Quantifying the Current U.S. Fiscal Imbalance"

Gary Burtless, "Social Security's Long-Term Budget Outlook"

Jonathan Skinner and Elliott Fisher, "Regional Disparities in Medicare Expenditures: An Opportunity for Reform"

Leonard E. Burman and Peter D. Ricoy, "Capital Gains and the People Who Realize Them"

Robert P. Harvey and Jerry Tempalski, "The Individual AMT: Why It Matters"

William G. Gale and Janet Holtzblatt, "On the Possibility of a No-Return Tax System"

David R. Seltzer, "Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company"

David A. Weisbach, "Should a Short Sale against the Box be a Realization Event?"

Robert J. Shapiro, "Building a Conceptual Baseline for Corporate Tax Reform"

Julie-Anne Cronin, "The Economic Effects and Beneficiaries of the Administration's Proposed Higher Education Tax Subsidies"

Barbara Miles and Dennis Zimmerman, "Reducing Costs and Improving Efficiency in the Student Loan Program"

Michael S. McPherson and Morton Owen Shapiro, "Financing Undergraduate Education: Designing National Policies"

William F. Fox and Matthew N. Murray, "The Sales Tax and Electronic Commerce: So What's New?"

Walter Hellerstein, "Transaction Taxes and Electronic Commerce: Designing State Taxes that Work in an Interstate Environment"

Robert Strauss and Jon M. Peha, "A Primer on Changing Information Technology and the Fisc"

Joann M. Weiner, "Discussion of Papers on Transaction Taxes and Electronic Commerce"

Eileen Mauskopf and Dave Reifschneider, "Dynamic Scoring, Fiscal Policy, and the Short-Run Behavior of the Macroeconomy"

Eric Engen, Jane Gravelle, and Kent Smetters, "Dynamic Tax Models: Why They Do the Things They Do"

Frank Sammartino and David Weiner, "Recent Evidence on Taxpayer's Response to the Rate Increases in the 1990s"

NTA Will Honor Richard Goode at Chicago Conference

Noted economist Richard Goode will receive NTA's Daniel M. Holland Medal for distinguished lifetime contributions to the study of public finance. The award will be presented at the 90th Annual Conference on Sunday, November 9.

Dick Goode has had a long and outstanding career with the federal government (Bureau of the Budget, U.S. Department of the Treasury), academia (Johns Hopkins University, University of Chicago), the International Monetary Fund, and The Brookings Institution. He also has been a consultant to Treasury, the United Nations, and the World Bank.

In addition to many articles in professional journals and conference volumes, his publications include *The Corporation Income Tax* (1951), *The Individual Income Tax* (1964, 1976), *Government Finance in Developing Countries* (1984), and *Economic Assistance to Developing Countries through the IMF* (1985).

He has been an active member of NTA for more than a half-century. He served as the first Assistant Editor of the *National Tax Journal*, and has written a special feature for the upcoming 50th Anniversary issue in December.

The previous recipients of the medal are Richard Musgrave, Carl Shoup, and George Break.

Welcome, New NTA Members!

Richard H. Bartholomew, Old Greenwich, Connecticut

Thomas Beam, New Jersey Department of Treasury

Bruce Billings, University of Arizona, Tucson

Cindy Blanthorne, Arizona State University, Scottsdale

Christopher Briem, University of Pittsburgh

Donald Bruce, Syracuse University

Scott Darragh, Michigan State University

Barbara M. Edwards, Georgia State University

Brad Guske, University of San Diego Law School

Roderick Hill, University of New Brunswick

Anita L. King, American Medical Association

Roman Konieckza, Tax Chamber of Poland

Andrew Lee, University of California, Davis

Chantee Lewis, Bryant College (retired)

Chi-ang Lin, National Chengchi University, Taipei

Roger L. Lirely, Western Carolina University

Steven R. Maguire, Atlanta

Michael B. McDonald, Ernst & Young, Reston

Ritu Nayyar-Stone, The Urban Institute

Gardner Neely, Georgia State University

Terry Olson, Truman State University, Kirksville, Missouri

Jon D. Perkins, University of Illinois, Champaign-Urbana

Jonathan M. Siegal, University of California, Berkeley

Jean Tesch, U.S. Department of the Treasury (Sarajevo)

Michael Williams, UCLA

Stephen A. Woodbury, Michigan State University

Stephanie Zobay, Georgia State University

Hellerstein Cites NTA in Testimony on Internet Tax

In July 17 testimony on H.R. 1054 ("Internet Tax Freedom Act") before the Subcommittee on Commercial and Administrative Law of the House Committee on the Judiciary, Walter Hellerstein urged that the subcommittee:

> First and foremost . . . pay close attention to the precise language of H.R. 1054 in light of what may be unintended consequences of the legislation. Second, I would urge the Subcommittee to consider carefully whether it intends through H.R. 1054 to enact a "moratorium" on state taxation of the Internet, as that term is commonly understood, and, if so, whether H.R. 1054, if enacted into law, would constitute such a moratorium. Third, I would encourage the Subcommittee to enlist those with expertise and experience in the fields of state and local taxation in establishing the consultative group charged with developing policy recommendations for congressional legislation in this domain. . . .

Elaborating on the last point, he said:

> . . . While in general I have refrained from either supporting or opposing H.R. 1054 on the merits, I wholeheartedly endorse Section 4 of the bill that establishes a consultative group to examine the complex problems raised by taxation of the Internet and interactive computer services and to submit appropriate policy recommendations to solve these problems. . . .
>
> As I mentioned at the outset of my testimony, Congress lacks the depth of expertise in this area that it has in many of the other areas in which it traditionally legislates. Therefore, it is particularly important for Congress to include those with the requisite expertise and experience in the deliberative process. *In particular, the Subcommittee may want to work with the National Tax Association-sponsored Committee on Taxation of Telecommunications and Electronic Commerce, which includes a broad spectrum of interested and knowledgeable private and public sector parties who are currently engaged in fashioning a solution to the complex problems to which H.R. 1054 is addressed.* (Italics added)

The First Conference on Taxation—November 1907

The National Tax Association and the Conference were front-page news November 14 and 15, 1907, in the *Ohio State Journal*, *Columbus Evening Dispatch*, and *Columbus Citizen* (which headlined one story "Foote is Head of Tax Association—No Pun Intended").

Nearly 200 of the nation's most prominent tax experts were named by the governors of the respective states as delegates to the first National Conference. Included among the delegates were three governors, commissioners from 34 states and three Canadian provinces, presidents of state tax associations, members of state tax commissions, and professors of economics. Governor Curtis Guild, Jr., of Massachusetts was permanent chairman of the Conference, which was called to order by NTA President Allen R. Foote.

The conference was called "in order to gain expressions of opinion from leading thinkers on the subject of taxation, with which many boards and commissions throughout the United States and Canada are grappling."

Governor A.L. Harris of Ohio gave the welcome address, in which he complimented the delegates for coming together to discuss what he termed the most important question before the American people—uniform taxation. "The demands for revenue are increasing more rapidly than taxable property," he said; "the tax rate is increasing and more intangible property is going into hiding." He urged the delegates to agree on a concrete uniform tax system.

Governor Curtis gave the opening address. As reported in the *Columbus Citizen*, he said that the nation should not interfere with the states in their sovereign right, particularly in matters of taxation. He took issue with President Roosevelt and Secretary Taft, who favored a national inheritance and graduated income tax. He declared that the system meant "double taxation for the benefit of a national treasury now burdened with a surplus." Further, he said:

> Before resorting to the desperate remedy of national laws, possibly involving a violation of the national constitution and certainly taking from the states the sources of revenue assigned to them from the beginning, is it not worth while to try for uniformity of state law that nowhere in any one state may the tax dodger find release from the full contribution which he owes to the government, which at once protects his enterprise and his fortune.

The Conference produced official NTA resolutions:

> . . . declaring the inheritance tax should be reserved to the states and not usurped by the national government; declaring for amendment of state constitutions, where necessary, to enlighten restrictions of taxation by legislatures; for the taxing of the same property in only one jurisdiction at the same time; against retaliatory tax legislation, as state war; for the exemption of all forms of public debts from taxation; for placing the main reliance of state revenues in subjects different from those used by local government, and making possible, if desired, limited local option in taxation. (*Ohio State Journal*)

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