NTA Forum

Perspectives, Ideas and News from the National Tax Association

Number 22, Summer, 1995

From the Editor

It is gradually becoming clear that many of the significant changes in federal programs that are making their way through the congress have implications beyond those that are apparent on the surface. Among the most important are the probable effects on state and local finances and tax structures.

In this issue Steve Gold, Director of the Center for the Study of the States at the Rockefeller Institute, SUNY-Albany, identifies the major effects on state/local finances and attempts to predict how states will respond. The states differ greatly in fiscal condition, tax structures, and political makeup. Yet, if any generalization is possible from Gold's analysis, it is that the states will face serious fiscal challenges making it almost certain that taxes will need to be increased, or services significantly reduced. It is not too early to start thinking about the choices.

The editor invites readers' comments on Gold's analysis and on the policy options faced by the states.

This article is Steve Gold's second in the *NTA Forum*. In the very first issue, in June, 1989 he wrote about the fate of tax reform programs put the the voters by initiative or referendum. Since then, more than 20 other leading figures in taxation and public finance have set forth their ideas in these pages, covering a wide variety of federal, state, and local topics.

This issue also marks the last under my editorship. As noted elsewhere in this issue, Bob Ebel will soon take over as Executive Director of NTA and he (or some new appointee) will assume responsibility for the *NTA Forum*. To help the new editor, it seems appropriate to invite feedback from readers: Are

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Impacts of the Revolution in Federal Policies on State and Local Governments

Steven D. Gold
Director, Center for the Study of the States, Rockefeller Institute, SUNY-Albany

Steven D. Gold

This period could go down in history as a major turning point for the American federal system. We are moving away from not only the Great Society but also parts of the New Deal. One federalism expert has even said that Washington has the feel of Paris during the French Revolution!

It is too early to tell whether we are on the threshold of a fundamentally new era. How much spending will be cut and how programs will be restructured this year are still uncertain, particularly because the President could use his veto to block some changes. In fact, the biggest questions won't be confronted in 1995 but later—whether a balanced budget amendment will be approved by Congress and ratified by the states and whether the federal income tax will be converted into a flat tax or replaced by a consumption tax.

What would all of this mean for state and local governments? Each of three initiatives—converting federal aid into block grants, adopting a balanced budget amendment, or replacing the federal income tax as we know it—would have profound implications for state and local governments. If two or three come to pass, the ramifications will multiply.

A major result of these changes would be to shrink the federal government's role in the federal system. States would play a correspondingly larger role, but how they would respond to the new challenges is extremely difficult to predict because the situation would be unprecedented.

To provide a context for understanding the issues, we'll review some of the main features of the existing intergovernmental system and then consider each of the prospective changes—block grants, the balanced budget amendment, and federal tax reform. We'll conclude by relating these developments to the changes already occurring in state and local policies.

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The Existing System

In 1981, President Reagan cut federal aid to state and local governments from $94.8 billion to $88.2 billion. Since then, aid has not been a high profile issue in Washington. There was little follow through to the 1981 reduction. Although President Reagan continued to advocate cuts as long as he occupied the White House, few of his proposals were adopted. Aid gradually increased through the 1980s and then rose sharply beginning in 1989.

Federal aid to state and local governments in the current fiscal year is projected to be $228.0 billion. In real dollars, that is 56% more than in 1989 and 64% higher than in 1982. As a proportion of GDP, aid fell from 3.2% in 1981 to 2.4% in 1989 but has rebounded to 3.2%.

A majority of this increase was for Medicaid, which now represents 39% of total federal aid, up from 18% in 1981 and 28% in 1989. Most of Medicaid's growth was caused by rapid health cost inflation and caseload growth due to increased poverty, AIDS, and other factors, such as federal mandates that expanded coverage. But part of the increase is attributable to state strategies to maximize federal aid, for example, by shifting existing health programs into Medicaid and taking advantage of provisions that enabled states to obtain aid without using any of their conventional tax revenue as matching funds.

States vary greatly in how aggressively they have pursued federal aid. Michigan has been one of the most ingenious states. Between 1990 and 1992, while its tax revenue fell, federal aid rose 41%, enabling it to survive a fiscal crisis without increasing taxes at all. New Hampshire is another state that cleverly shaped its programs to augment federal aid.

Most other states were not as aggressive in their Medicaid financing strategies. Most states did increase taxes significantly in the early 1990s to keep their budgets out of the red. But nationally federal aid to states rose 34% between 1990 and 1992, while state tax revenue increased only 9%.

While some of the old strategies that enabled states to increase federal aid are still in effect, the federal government has significantly tightened its Medicaid regulations, causing serious budget problems for some of the states that were leaders in pursuing federal aid.

To provide a balanced view, federal aid should be considered in the light of the mandates that the federal government imposes on state and local governments. A large share of federal aid is merely compensation for part of the cost of services that the federal government requires states to provide. But within this system where the federal government writes the rules, states have recently been able to obtain more aid than was envisioned when programs were designed.

During the early 1990s, the states have benefitted from a large increase in federal aid, tending to offset the continuing burden of complying with federal mandates.

Intergovernmental relations can be seen as a tug of war between the federal government and the states, with the federal government usually having the upper hand. During the early 1990s, however, the states have benefitted from a large increase in federal aid, tending to offset the continuing burden of complying with federal mandates.

Block Grants

Approximately half of federal aid is provided through open-ended matching grants. The federal government does not directly control how much is spent in such programs; it simply provides aid in some proportion to what states and localities spend. For example, for Medicaid and Aid to Families with Dependent Children, the federal share varies from 50% to about 80%, with higher matching rates in low income states.

This is going to change. Block grants (which usually do not require a match) will be substituted for most if not all matching grants. In addition to not requiring states to match federal aid, block grants have four other characteristics: (1) They are broader in scope and offer greater state discretion than categorical programs. (2) They allocate funds by a statutory formula based on statistical factors like population and income rather than as individual grants for particular projects. (3) Federal spending is limited in advance (as is true for some but not all categorical grants.) (4) They are successors to existing programs, which may be either grants or federally-operated programs. This implies that block grants cannot be analyzed by themselves. They have to be judged in comparison with the programs they replace.

Many block grants are being considered this year, covering such programs as welfare, foster care and child abuse, child care, nutrition, housing, health care, and employment and training.

History. Block grants are not new. They originated in the Johnson Administration, expanded under President Nixon, and were an important element of the 1981 Reagan program. Nine block grants were enacted in 1981, consolidating more than 50 categorical programs. The 1982 appropriations for these grants were $7.3 billion, 12% less than in 1981.

Most of the Reagan block grants did not keep up with inflation in later years. Only two of the nine had real spending increases between 1983 and 1993, while six fell 17% or more in real dollars.

Several more block grants have been created since 1981, for child care and development, job training, transit capital and operating assistance, and surface transportation. There are now 15 block grants with total funding of $32 billion.

What is being contemplated now is a vast expansion of block grants compared to what has gone before. For the first time, block grants would replace entitlement programs, such as welfare and Medicaid.

Block grants have numerous effects, depending on the nature of the programs that go into them, the restrictions the federal government imposes, and funding levels.

Less aid. The proposed block grants will reduce federal aid to states by capping future increases. In fact, one of the principal motivations for adopting block grants is to make large federal spending reductions more palatable. While such reductions will help to reduce the federal deficit, they also will add considerably to state and local fiscal stress. Although funding for most of the proposed block grants is projected to increase over the next five years, the growth is less than what would be required to offset inflation and the rise in the number of eligible people.

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The initial effects on state budgets will grow substantially over time, particularly when a recession occurs. During a recession, the number of people needing programs like Medicaid and welfare increases sharply. Under many current programs, this automatically results in higher federal spending because aid is open-ended (or, in the case of food stamps, because the federal government pays for all benefits). If these programs are converted into block grants, states will be responsible for dealing with the increased caseloads themselves. States could use up all of the federal funds before the end of the fiscal year, requiring them either to provide supplemental funding from their own revenue or else to curtail the program.

Less incentive to spend. Block grants stimulate state spending less than open-ended matching grants. Now, for example, if a state spends another $100 million on Medicaid or welfare, it costs only $25 million to $50 million because federal aid pays the balance. Under a block grant, there is no increase in federal aid if that $100 million is spent. Because matching grants reduce the effective price of spending while block grants do not, switching to block grants reduces the incentive for states to spend their own funds.

The abandonment of open-ended matching grants removes a major tool through which the federal government can influence state spending. The federal government has used such grants to encourage state and local governments to provide services that address national rather than state problems. Unless the federal government imposes new unfunded mandates requiring such services, they will be under-supplied.

Less paperwork. Proponents of block grants emphasize administrative savings and reduced paperwork requirements. Top officials of the Reagan administration suggested in 1981 that cost savings might be as large as 25%. Budget director David Stockman, for example, claimed that despite aid cutbacks "... services delivered need not be diminished because massive reductions in Federal administrative requirements also are being made."

Although the 1981 block grants did reduce paperwork, the amount of money saved was much less than Reagan officials predicted. All 19 states analyzed in an Urban Institute study "characterized it as small relative to initial federal funding reductions."

More flexibility. Another effect of block grants is the flexibility resulting when several grant programs are combined, allowing states to shift resources among them to better satisfy local priorities. However, this benefit does not apply when a single large program goes into a block grant, such as AFDC. Often block grants are combined with relaxation of federal regulations. But if such freedom is desirable, in some cases it could be provided without switching to block grants.

The distribution of block grant funds among states is going to be controversial. Some states received much more than their proportional share of federal aid from the prior matching grants. Maintaining the existing distribution will not be politically tenable for long.

To summarize, block grants have several effects—lower federal aid, reduced incentive for states to spend their own funds, administrative savings, and enhanced flexibility. Over time, they will result in much less spending and lower benefits and services for needy individuals, a significant reduction in safety net programs.

Although funding for most of the proposed block grants is projected to increase over the next five years, the growth is less than what would be required to offset inflation and the rise in the number of eligible people.

Balanced Budget Amendment

The federal spending cuts being considered this year can be viewed as a first installment moving toward a balanced federal budget. Although the constitutional amendment to require a balanced budget in 2002 fell one vote short of approval by the Senate, the odds favor its passage no later than early 1997. One of the Senators who voted against it could change his or her position or leave office and be replaced by a supporter. If neither of those things happened, there is a good chance that the 1996 elections will change the Senate enough for the amendment to pass.

How the budget would be balanced is very difficult to predict, but federal aid to state and local governments would certainly be cut sharply. In one simple scenario (no tax increases, no cuts in Social Security or defense, proportional cuts in the rest of the budget, tax cuts as proposed in the Contract with America), aid would be cut approximately 30%. This is not a worst case scenario.

As already mentioned, federal aid this year is projected to be $228 billion. A 30% cut would be $68 billion. This can be compared with total state tax revenue, which is approximately $390 billion. To replace the entire aid cut would require a 17% increase in state taxes.

States would not raise taxes anywhere near that much. What they would do is reduce spending for their own programs and for aid to local governments. In other words, states would pass along many of the federal aid cuts to poor people and to local governments.

One of the biggest impacts would be less spending for schools, which consumes nearly a third of state tax revenue. This illustrates a paradox. Local governments will lose much less federal aid than states because nearly 90% of aid goes to states. But when federal aid for state health and social programs is cut, states will respond in part by reducing local aid. Education has less to fear from direct losses of federal aid than from this ricochet effect.

While a 30% reduction seems enormous, it would just reduce federal aid back to its level of 1990 or 1991. That doesn't sound so threatening. But remember that most of the ensuing increase was for Medicaid. Health cost inflation and bigger caseloads made its cost soar. Poverty has also grown considerably, increasing the need for many other programs.

Federal Tax Reform

Each of the three major proposals that have surfaced this year to replace the federal income tax—Representative Richard Armey's flat tax, Senators Nunn and Domenici's consumption tax, and Senator Lugar's sales tax—would have major effects on state finances if they were enacted as currently proposed.

First, there would be no deduction for state and local income and property taxes. This would substantially raise the cost of paying these taxes for the many households who currently take advantage of those deductions. Tax resistance would intensify.

Second, since all interest earnings would be free of taxation, municipal bonds would no longer benefit from having their interest excluded from the tax base while interest on other bonds is taxable. Interest rates on state and local bonds would be higher not lower than those on Treasury bonds. Unless the general level of interest rates fell very sharply, the interest rate for municipal bonds would rise.

Third, states would be under great pressure to conform their own personal and corporate income taxes to the base of a federal flat tax or a Nunn-Domenici consumption tax. For administrative and compliance reasons, states would probably follow the current practice of tying their own taxes to the federal tax code's measure of income (or consumption). They would, however, not necessarily conform to the low-income allowances in the Armey and Nunn-Domenici plans and would of course set their own tax rates, as they do now.

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It is not as clear how states would respond if the federal government replaced the income tax with a sales tax, since 45 states already impose a sales tax (and it is the largest revenue source for most of them). It would, however, be much more difficult for states to administer their own income taxes if the federal government did not have one.

Most of these changes would depress state revenue growth over time. Revenue from a flat tax or national sales tax would grow more slowly than most existing state income taxes because taxpayers would not move into higher tax brackets as their income rose. A national sales or consumption tax would tend to reduce state sales tax bases.

Aside from these implications of fundamental federal tax reform, states would also be affected by the tax proposals enacted this year by the House of Representatives. Most states would, for example, conform to the treatment of capital gains, depreciation, and IRAs, significantly reducing state tax revenue growth over time. There would be a negative windfall that is the mirror image of the positive windfall that could have been received after the Tax Reform Act of 1986. Most states cut their tax rates and increased personal exemptions and standard deductions to avoid that earlier windfall, but would they do the opposite now?

Adding It All Up

All of the federal changes would have the effect of shrinking the federal government. For several reasons, they would also tend to reduce state spending and revenue—less incentive to spend without matching grants or deductibility of income and property taxes, less federal aid, higher cost of borrowing, and less state revenue growth as a result of tax reform. In addition, there would be a psychological effect: If all of this happened, it might send a message that citizens really want less government.

There would, however, be a countervailing force. While people favor decentralized government and less federal intrusion into state and local affairs, they still want high-quality government services. If the federal government bails out, it will be necessary for state and local governments to fill part of the vacuum. States will not cut taxes as much as would be predicted due to the shift to block grants and the loss of deductibility of income and property taxes.

The federal changes would thrust states into a much more prominent role in our federal system, turning the clock back to before the New Deal, which (along with World War II) made the federal government ascendent.

State governments are radically different from the way they were before the 1930s. They are more representative (thanks to the Supreme Court's one person-one vote decision) and more competent because of modernization of their operations that took place in the 1960s and 1970s. Little can be deduced from their policies more than 60 years ago. Some things can, however, be predicted based on trends in the past decade.

Because matching grants reduce the effective price of spending while block grants do not, switching to block grants reduces the incentive for states to spend their own funds.

Adoption of the Republican agenda would accelerate the rethinking of past practices that is already taking place. The best seller Reinventing Government called on state and local governments to become less bureaucratic and more market-oriented—to reform procurement, personnel, and other policies. One of the main findings of a book I recently edited, The Fiscal Crisis of the States,1 is that states are indeed experimenting with many of the reinvention themes, although it is too soon to conclude that such initiatives are great successes. No state has discovered the Holy Grail enabling it to provide much more service with much less money. The fiscal shock caused by the loss of federal aid and other Republican changes will weaken the resistance to changes in the traditional ways of providing services.

Another important trend is what John Shannon dubbed "fend-for-yourself federalism." States have been gradually pushing more responsibilities to local governments. One sign is that local taxes have risen faster than state taxes every year since 1985. This off-loading of responsibilities will continue if not accelerate, with aid to local governments certain to be cut more than spending for state operations.

Such fiscal decentralization will put pressure on property taxes and encourage further adoption of local sales taxes. It will also result in greater inequalities between rich and poor places, just as there will surely be greater disparities between affluent and low-income households in general.

The Republican proposals would not affect all states equally. High-tax, high-spending states would suffer the most from loss of federal deductibility, while some low-income states that receive disproportionate benefits from federal programs would lose heavily from federal aid cutbacks.

Will all of this come to pass? Increased reliance on block grants is inevitable, but the balanced budget amendment and abandonment of the existing federal income tax are not sure things. The public has inconsistent wishes—for lower taxes but against major reductions in government benefits. The resolution of this conflict is a question mark. The stakes are enormous, for the country in general and for state and local governments in particular. One hopes that decisions will not be made about the last two parts of the Republican agenda until there is a careful consideration of the issues.◆

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From the Editor *(cont'd from page 1)* the articles interesting, readable, and useful? Are there other kinds of material the *Forum* should include? What kinds of material could be omitted? Are there changes in format or in frequency that would be desirable?

Please send you thoughts on these or other matters to me at the NTA office.

As always, the *NTA Forum* welcomes suggestions for or submissions of short articles on other topics that would be of interest to the wide range of public finance professionals represented in NTA mambership.

Fritz Stocker, Editor

New Members

The Association is pleased to welcome the following new members who have joined between April 1, 1995 – May 31, 1995.

NAME	STATE OR COUNTRY
Paul Apodaca	TX
Gary K. Brough	UT
Mingtao Chen	ON
Colorado State University	CO
Amy D. Crews	NY
Kazumasa Iwata	Japan
Sharon Lawrence	DC
Susan C. Nelson	DC
Steven H. Smith	AZ
James W. Wetzler	NY
The Williams Companies	OK
David Wulf	OK

35 Years Ago with the NTA

Tax Policies and Economic Growth

". . . there is still too little general comprehension of the degree to which a wisely constituted tax structure has the potential to create as well as to destroy. In a broader sense, creative tax policy is the key to solution of great problems confronting us in this world of swift change, danger and opportunity. Tax policy, therefore, is far from being an academic subject as all of you so well know. It is, rather, a vital economic element affecting the lives of all Americans — and America's position in the world.

Our tax related economic problem is two-fold: First, to provide adequate tax revenue to finance the increasing costs of national security and the needs for services of a growing population, and second, to revise our tax structures so as to provide at the same time for incentives to encourage a higher rate of capital investment in new plants and equipment in order to speed up our economic growth rate and thus produce more and better jobs.

. . . Accelerated economic growth is the long term answer to the revenue problem. For if our total output and income — the base upon which most of our taxes are levied — can show sufficiently vigorous growth, revenue yields can be realized to meet expanding federal, state and local needs of almost any foreseeable dimension. On the other hand, a tax structure that fails to provide the investment incentives upon which growth depends must have recourse to ever-increasing tax rates. These are self-defeating because the yields are limited by the static or declining base that a restrictive tax structure can produce."

Governor Nelson A. Rockefeller, in a luncheon address at the Fifty-Third Annual Conference on Taxation, New York City, September 6, 1960

NTA Home Page

The NTA "Home Page" on the World Wide Web is operational. It provides information about the Association, summaries of selected papers from the 1995 Spring Symposium, and results of a 1994 survey of the membership regarding tax policy. The Page also provides a link to the host, Arizona State University College of Business, which has many links to Internet resources.

Future uses planned for the Home Page include links to summaries of past and future articles from National Tax Journal and a link to program information for the 1995 Annual meeting as it becomes available.

Access to the NTA Home Page is available to the public via the Internet to anyone with "web browser" software such as Mosaic or Netscape. The address is http://www.asu.edu/cwis/business/nta.html, although it will change later this year when a new server becomes available.

Visit the Home Page and provide feedback by "clicking" on the email link to Charles Christian (charles.christian @asu.edu) at the bottom of the page.◆

Jean O'Neil Retires after 21 Years with NTA

Jean M. O'Neil, an NTA staff member for more than 21 years, retired on May 31. Her responsibilities consisted primarily of maintaining membership and subscriber records and fulfilling orders for NTA publications.

The Board of Directors at its May 23 meeting adopted a resolution of appreciation thanking her for her long and devoted service to the Association, and wishing her happiness and good health in retirement.◆

We invite you to join us in our work

APPLICATION FOR MEMBERSHIP

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I wish to become a member of the National Tax Association.

My check for $____________ is enclosed for the payment of annual dues. I understand that $50.00 of my dues ($55.00 for foreign members) covers the subscription cost of *The National Tax Journal*, and that I will receive the *Proceedings of the Annual Conference*, the *NTA Forum*, and all other publications of the Association at no additional cost.

Sustaining Member	$ 500.00 or more
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Professional, corporate employee, others	$ 120.00
Library	$ 100.00
Government employee or academic	$ 70.00
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* Allows up to three individuals in case of corporations, up to five in case of government agencies.

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Ebel to Become NTA Executive Director

Robert D. Ebel has been named by the NTA Board of Directors to become the new Executive Director of the Association. Bob will assume his new duties on or about August 1. He will succeed Fritz Stocker, who is retiring after having held the position for the past eight years.

A prominent authority on intergovernmental relations and fiscal decentralization, Bob is currently Senior Economist for the Europe-Central Asia and Middle East Regional Divisions of the World Bank. Previously he directed public finance research for the Advisory Commission on Intergovernmental Relations. He also has directed comprehensive tax studies for the legislatures of Minnesota, Nevada, and the District of Columbia, and has conducted research projects and provided expert testimony to numerous other state and local bodies and to the U.S. Congress.

His publications in the field of public economics include authoring or co-authoring 15 books and monographs and more than 25 professional articles. His most recent book (co-edited with Richard Bird and Christine Wallich), *Decentralization of the Socialist State,* was published recently by the World Bank.

A native of Ohio, Bob received his undergraduate degree in economics from Miami University. He then went on to graduate work at Purdue University, where he received his Ph.D. in Economics in 1971. He has been an active member of NTA since 1967 when his major Professor, James Papke, introduced him (as he does all his students) to the organization.

Since then Bob has served the Association in many capacities. From 1985 to 1987 he chaired the Committee on State Income and Business Taxation, and from 1988 to 1992, the Committee on Intergovernmental Fiscal Relations. He has appeared often on NTA conference programs, served several times on program committees for the Annual Conference and the Spring Symposium, and chaired the Program Committee for the 1989 Annual Conference (Atlanta). From 1990 through 1993 he was a member of the Association's Board of Directors.

In addition to his government service, Bob has served in academia and the private sector. He has held tenured academic positions at the University of Hawaii and the University of the District of Columbia, a visiting professorship at Purdue, and an adjunct professorship at American University's Graduate School of Public Administration and Institute for Applied Financial Management.

While in Minnesota, where in 1983–85 he headed a major state tax study, Bob served as a member of the Board of Directors of the Minnesota Tax Foundation and Editor of the Minnesota Tax Journal.

Bob will discharge his NTA responsibilities from an office in Washington (the address to be announced soon) and will retain his residency there. The business functions of the Association will remain in the present Columbus office, under Executive Assistant Janet L. Staton.◆

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