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## Evolution of U.S. Fiscal Federalism

Through GAO's affiliation with the American Consortium for International Public Administration, the Office was asked to prepare a paper on trends in fiscal federalism for the International Institute of Administrative Sciences. This article is the result of that request.

The federal system of government was a logical choice for a nation which arose from a group of separate entities—the 13 colonies which became the first 13 States. However, the fear of a strong central government was pervasive enough when the new Nation was organized that the power to raise revenue was given to the States, with the national government assigning certain expenses to each one. Sometimes the States would pay their assessed shares, in other instances they would not. At that time (1781-1788) the fundamental framework of U.S. government was embodied in the Articles of Confederation. When it became apparent that this system of government was not the best, a new Constitution, effective in 1789, was adopted.

Under the Constitution, the U.S. Congress received the power "to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States." Thus the Federal Government has concurrent jurisdiction with the States in nearly all fields of taxation. This also marked the beginning of presidential government: although the colonies had declared themselves independent states in 1776, there was no chief executive until President George Washington assumed the post in April 1789.

### Early Stages

The first half of the 19th century was a time of rapid geographic expansion and industrial growth. The national government established itself as the recognized focal point of government. However, State governments also gained political strength, all the while maintaining diverse sectional interests which culminated in the 1861-1865 Civil War between the United States and the secessionist Confederate States of America. The strong role played by the Union (Washington)

government to win the war and mold the country into a single nation had the effect of weakening the role of State governments. In fact, many Southern States revised their constitutions in the last two decades of the century, and in so doing, restricted the powers of their legislatures and governors greatly.

The first quarter of the 20th century saw little change in the proportion of taxes collected and funds spent by each level of government. The Federal Government spent approximately 20 percent of the funds devoted to nonmilitary purposes while State and local governments (including counties, cities, and towns) spent about 80 percent. However, the structure of the tax system changed radically during this period. In 1902, income taxation was so small a portion of tax revenue that precise statistics were not kept on the percentage of tax revenue it comprised. By 1927 income taxes comprised 64 percent of Federal and 10 percent of State tax revenues. In 1902 consumption taxes (such as sales and liquor taxes) accounted for 95 percent of total Federal revenue and 18 percent at the State level. By 1927 these had declined markedly as a share of total Federal tax revenue but were increasing at the State level. Only local forms of taxes remained relatively consistent—property taxes provided almost all local tax revenue.

### Impact of the Depression

The economic havoc wrought by the depression of the 1930's did more to change the intergovernmental financial picture than all of the events of the preceding 140 years. It quickly became clear that State and local governments could not mount the massive relief and welfare efforts needed. Property taxes simply were not paid by families whose breadwinners were unemployed, and the economic chaos was heightened by massive crop failures due to drought. State governments did not have the resources or administrative mechanisms to effectively rescue local units.

This, then, was the climate in which President Roosevelt created the "New Deal"—a complex combination of public works projects, work relief, and direct

financial assistance. In 1935 the Social Security system was created by legislation which provided for a Federal program of old-age insurance. It established a Federal-State system of unemployment insurance and an extensive system of grants for public assistance. State and local governments were called upon to participate in these programs and were reimbursed for about half their costs.

At about the same time, the judicial branch also began to rule in favor of a more integrated Federal system. The Supreme Court had formerly tended to rule more in favor of stricter boundaries between Federal and State activities. During the New Deal era, however, the Court interpreted the national government's responsibility to provide for the "general welfare" as one not bound by judicial restrictions on the amounts or purposes of Federal spending.

Thus, the Federal Government's role expanded greatly, not only in terms of financial assistance, but also with respect to regulatory activities. A prime target of Federal oversight was the finance industry. Aspects of investment activity and banking practices were restricted, and many regulations were designed to protect the consumer. While there were those who argued at the time that State governments had been ineffective in meeting the various economic crises and should be dissolved, in retrospect it is possible that the magnitude of the Depression only forced a stronger Federal role in a system of finance which itself was expanding far beyond the bounds foreseen by the framers of the Constitution.

## Post-World War II Shifts

World War II also had a dampening effect on State and local spending patterns. Between 1940 and 1944 Federal spending rose from \$10.1 billion to \$100.5 billion, while State and local spending declined from \$11.2 billion to \$10.5 billion. However, when the war ended, the Federal Government quickly dismantled its military machine and withdrew to its prewar activities.

The Federal Government's role as promoter of economic stabilization was formally recognized in the Employment Act of 1946, which established a national goal of full employment. This legislation reflected a shift in thinking

rather than a series of Federal programs.

The 1950's also saw a change in intergovernmental fiscal relations. With the population boom and increased use of the automobile after World War II, State and local spending was devoted primarily to schools, roads, and other facilities and infrastructure requirements needed to accommodate a population shift from central cities to suburbs. The Federal Government contributed to much of this development through Federal grants, particularly for highway construction, and through Federal programs to stimulate the availability of financing for home construction and purchase in the suburban areas.

## Most Recent History

In raising revenue to meet their expenses, the three levels of government use somewhat different sources. Currently the Federal Government gets approximately 45 percent of its revenue from individual income taxes, 30 percent from social insurance receipts, and 12 percent from corporate income taxes. Another 13 percent comes from excise taxes, borrowing, and other sources. States also use the income tax source (26 percent from individuals and 10 from corporations) but obtain most revenue from sales taxes (51 percent). Eleven percent comes from miscellaneous sources, such as motor vehicle and estate taxes. Property taxes are now almost the exclusive domain of local governments, which raise 77 percent of their revenues from this source. Thirteen percent is derived from sales taxes, while 6 percent is from individual income tax and 4 percent from other sources.

Despite the variety of income sources available to them, during the 1960's State and local governments found themselves unable to expand their revenue base as quickly as residents increased their demands for services. This situation was somewhat eased by the Federal Government's expanded role (through what became known as President Johnson's "Great Society" programs), which greatly increased grants from the Federal to State and local governments. Federal aid to State and local governments has grown from approximately \$7 billion in fiscal year 1960 to over \$90 billion in fiscal year 1981, with an annual growth

rate during the 1970's of about \$6 billion (15 percent) per year. The number of Federal programs providing assistance to these other levels of government climbed from 150 in 1960 to 498 in 1979. The purpose of many programs is to stimulate State and local action in behalf of stated national purposes, while a more limited number of programs support the ongoing operations of these governments. The programs cover almost every conceivable area (health, education, law enforcement, transportation, urban development, and others), and there are also many ways of dispensing the aid.

Some of the aid has gone directly to local governments, but the majority has gone to States or been funneled through States to local units. Some has been provided for specific functions or projects (categorical grants), while other funds have been for more general purposes within a given area (block grants). Revenue sharing has been popular with State and local governments, since it is provided with essentially no Federal instructions. Because of increasing complaints from State and local government recipients that Federal funds come with too many requirements which detract from actual program implementation, the trend has been shifting to more of the block grant or revenue sharing approaches.

This gradual shift has more recently accelerated, given that President Reagan's economic program calls for the return to State and local governments of responsibility for some of the programs the Federal Government now funds. The President plans to reduce the number of categorical grants and replace them with block grants. The changes also contemplate reduced Federal funding in many areas. At this point, it is too soon to project the long-term effects of these initiatives on intergovernmental fiscal relations, but it is probably fair to say that the balance of responsibility will shift somewhat from the Federal to the State and local levels.