United States General Accounting Office

GAO

Report to Congressional Committees

March 1990

FEDERAL-STATE-LOCAL RELATIONS

Trends of the Past Decade and Emerging Issues

GAO/HRD-90-34

GAO
United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-236593

March 22, 1990

The Honorable James Sasser
Chairman, Subcommittee on General Services,
Federalism and the District of Columbia
Committee on Governmental Affairs
United States Senate

The Honorable Ted Weiss
Chairman, Subcommittee on Human Resources
and Intergovernmental Relations
Committee on Government Operations
House of Representatives

This report provides information to the Congress on the key changes in the federal government's relationship with states and localities over the past decade. It also identifies emerging issues concerning these intergovernmental partnerships, which may be useful for the Congress to consider as federal policymakers approach the next decade.

Copies of this report are being sent to other congressional committees and subcommittees; the Director, Office of Management and Budget; the Chairman, U.S. Advisory Commission on Intergovernmental Relations; and other interested parties.

This report was prepared under the direction of Linda G. Morra, Director, Intergovernmental and Management Issues, who may be reached on (202) 275-1655 if you or you staff have any questions. Other major contributors are listed in appendix III.

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Executive Summary

Purpose

Federal-state-local relations have changed significantly over the past decade. Events and trends causing these changes have had both positive and negative effects on the capacity of state and local governments to carry out their responsibilities across a range of domestic programs and policies. This report discusses how changed federalism policies and federal budgetary retrenchment have worked to broaden the role of the states in the intergovernmental system, while federal regulatory trends have lessened state discretion but not state responsibilities. The report then links these factors to three emerging issues that the Congress should be aware of as it seeks to address the budget deficit and pursue other national priorities.

Background

Apart from a few programs, such as the administration of the social security system, the federal government is not a direct provider of domestic public services. Instead, the majority of national domestic programs are implemented through a complex partnership among federal, state, and local governments. Traditionally, grants-in-aid have formed the principal means of tying the intergovernmental system together. However, while federal grants-in-aid to states and localities totaled $95 billion in fiscal year 1989, they peaked in real terms in 1978. As a share of total state-local expenditures, federal aid shrank by one-third over the 1978-88 period. This decline contributed to a search for new ways to meet continuing demands for public services by many of the more than 83,000 units of government comprising the intergovernmental system and by the federal government itself.

Results in Brief

During the past decade, changing federalism policies and federal budgetary retrenchment resulted in an increase in the role of the states in the intergovernmental system. Subsidies to local governments were reduced and state authority over some kinds of federal aid was increased. States became more prominent over the decade as a result, but not without some adverse effects. The first emerging issue identified by GAO is that the fiscal gap between wealthier and poorer communities became larger over this period.

In contrast, trends in federal regulation lessened state discretion but not state responsibility. Despite certain Reagan administration efforts to minimize it, federal regulation of states and localities grew over the past decade. New regulations governing domestic programs were created, and federal preemption powers were expanded. This situation was cited by state and local officials whom GAO interviewed as the most negative trend of the past decade. It raises the second emerging issue GAO identified: while regulation is an important mechanism for the federal government to use to attain statutory objectives, its success often depends on the goodwill and cooperation of state and local governments to implement these federal regulatory programs. Yet, in this respect, tensions between the federal and state and local governments are mounting.

States have increased their prominence over the past decade and now stand at the threshold of the 1990s as highly visible leaders in a broad range of domestic policies. In part, this is due to the increased institutional and administrative capacity of states. Federal budgetary retrenchment has also thrust states into new and expanded roles. Sustained national economic growth has also contributed.

The third emerging issue that GAO identified, however, is that the combination of federal budgetary retrenchment and expanding regulation could place too much fiscal pressure and program responsibility on states, especially during periods when national or regional economies are weak. This, in turn, could slow—or even reverse—the trends in state prominence.

Principal Findings

Decentralization Driven by Changing Federalism Policies and Growing Federal Deficit

Changing federalism policies, tax cuts, and efforts to reduce the size of the budget deficit have helped to decentralize the intergovernmental system and increase the role of the states. In particular, federal aid for community and economic development, housing, and public infrastructure has been cut significantly, while program funding benefiting poor people has been largely maintained, and in some cases expanded. Because local governments have been the primary recipients of the former categories of aid, federal-local relationships, which developed in the 1960s and 1970s, were reduced (see pp. 15-19).

Increased Concerns About Intergovernmental Regulation

Beginning in the 1970s, budgetary pressures led federal policymakers to further national objectives through nongrant strategies, notably:

- regulatory requirements, in which the federal government calls on states and localities to administer federal rules;

- preemptions, in which state or local policies are preempted by national action; and
- direct orders, in which the national government directly orders state and local governments to take specified actions (see pp. 26-27).

Regulation is one of a number of fundamental powers the federal government has to attain statutory objectives. Even so, over the past decade, national regulatory trends lessened state discretion without reducing the scope of state responsibilities. Notwithstanding some Reagan administration efforts to reduce overall levels of intergovernmental regulation, the Congress, federal agencies, the courts, and the administration continued to use all three forms of regulation to expand and strengthen federal regulatory efforts (see pp. 27-31).

State Government Was Strengthened

States as a whole became more capable of responding to public service demands and initiating innovations during the past decade. Many factors account for strengthened state government. Beginning in the 1960s and 1970s, states modernized their governmental structures, hired more highly trained individuals, improved their financial management practices, and diversified their revenue systems (see pp. 33-37). Also contributing was the Reagan administration's philosophy of focusing program responsibility on states, thrusting these governments into new or increased leadership responsibilities (see pp. 40-41). Finally, since 1983, sustained national economic growth has provided many state and local governments greater financial stability. This, in turn, has given them more flexibility to plan for the future and address existing problems (see pp. 41-42).

Implications for Federal Policymakers

The events and trends of the past decade have created a paradox in intergovernmental relations with important implications for federal policymakers. Federal budgetary realities and changing federalism policies helped to cast states in a more prominent role in domestic policy in the 1980s than in the 1970s. At the same time, regulatory instruments provided alternative means to achieve national objectives when budgetary strategies proved untenable. In combination, these changes suggest that, overall, state fiscal health and institutional capacity to carry out domestic responsibilities may become more entwined with the actions of the federal government in the 1990s than was true in the 1970s.

Based on these past events and trends, GAO identified three broad issues that the Congress should be aware of in the coming decade:

- First, the federal government depends heavily on the institutional and financial capacity of state and local governments to administer its programs. Yet over the past decade, federal budget cuts helped to widen the fiscal gap between wealthier and poorer communities. This, in turn, is one warning sign that inequities in the levels of basic state and local public services (e.g., police, primary and secondary eduction, and infrastructure) may be increasing.
- Second, while regulation of states and localities is an important tool for the federal government to attain its statutory objectives, tensions among levels of government have mounted over the past decade as regulatory requirements, preemptions, and mandates increased (see pp. 48-49). The cumulative effect of these increases—coupled with decreasing federal aid—could force state and local governments to choose between meeting their service responsibilities and fulfilling national regulatory objectives. This kind of divergence between state, local, and national priorities is likely to reduce the effectiveness of these governments as agents of national regulatory policies and public service providers, especially during periods of economic decline.
- Third, by the end of the 1980s, states had reemerged as principal domestic partners with the federal government and policy leaders and program innovators in their own right. However, because states occupy an increasingly central place in the intergovernmental system, the combination of federal fiscal and regulatory trends poses a special threat to their leadership because it might slow—or even reverse—recent progress (see pp. 49-50).

Recommendations

GAO is making no recommendations.

Agency Comments

The contents of this report were discussed with national and state intergovernmental experts and agency officials with responsibility for intergovernmental programs. Their comments are reflected throughout the report.

Contents

Abbreviations

ACIR	U.S. Advisory Commission on Intergovernmental Relations
AFDC	Aid to Families With Dependent Children
CRS	Congressional Research Service
DEFRA	Deficit Reduction Act of 1984
EPA	Environmental Protection Agency
ERTA	Economic Recovery and Tax Act of 1981
FLSA	Fair Labor Standards Act
GAO	General Accounting Office
GRH	Gramm-Rudman-Hollings Act
GRS	General Revenue Sharing
IDB	industrial development bond
NGA	National Governors' Association
OBRA	Omnibus Budget and Reconciliation Act of 1981
OMB	Office of Management and Budget
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TRA-84	Tax Reform Act of 1984
TRA-86	Tax Reform Act of 1986
USDA	Department of Agriculture

Introduction

Background

Nearly all public services in the United States are jointly financed and delivered through the 50 state, 39,000 general purpose, and 44,000 special purpose local governments. This approach to public service delivery reflects the fact that the United States is a federal system in which responsibilities are both divided and shared among separate levels of government, each possessing a base of legal and fiscal authority.

Historically, responsibilities were more divided than shared. The states and, through them, local governments were preeminent in domestic policy. However, in the aftermath of the Great Depression the federal government increased its domestic commitments, creating a host of new programs and helping to finance the delivery of many more public services at the state and local level. Beginning in the Great Society period of the 1960s and continuing into the 1970s, the federal government again stepped up its efforts, adding substantially more local government grant programs to the existing mix of federal aid. Having examined these trends in detail, in 1981, the U.S. Advisory Commission on Intergovernmental Relations (ACIR) concluded that "... the federal role has become bigger, broader, and deeper—bigger within the federal system, both in the size of its intergovernmental outlays and in the number of grant programs, broader in its program and policy concerns, and the wide range of subnational [state and local] governments interacting directly with Washington; and deeper in its regulatory thrusts and preemption proclivities."[1]

States and localities spent $926.7 billion in 1987, as table 1.1. shows.

Table 1.1: State and Local Government Expenditures (1987)

Dollars in Billions

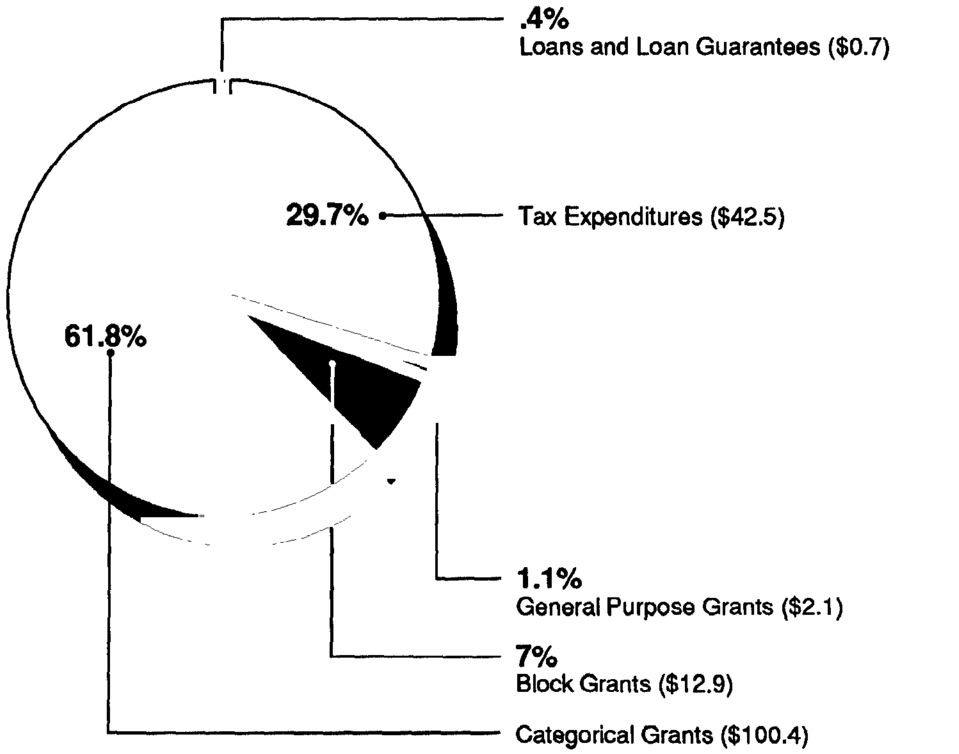
Type of government	Number	Total expenditures
State	50	$455.7
General purpose local governments	38,933	281.8
Counties	3,042	103.0
Municipalities	19,200	164.1
Townships	16,691	14.7
Special purpose governments	44,253	189.2
School districts	14,721	138.3
Special districts	29,532	50.9

Source: Bureau of the Census, Statistical Abstract of the United States, 1989, p. 266; and Governmental Finances, 1986-87, table 2.

[1] U.S. Advisory Commission on Intergovernmental Relations, The Federal Role in the Federal System: The Dynamics of Growth, A-86 (Washington, D.C.: U.S. Government Printing Office, June, 1981) p. 1.

Federal financial assistance to states and localities takes the form of grants-in-aid, tax subsidies, loans, and loan guarantees. Federal grants-in-aid were about $115.3 billion in fiscal year 1988. In addition, nongrant aid—in the form of tax subsidies, loans, and loan guarantees—amounted to nearly $50 billion (see fig. 1.1).

Figure 1.1: Distribution of Federal Outlays and Forgone Revenues for Intergovernmental Programs
(Fiscal Year 1988)



Source: Office of Management and Budget, The United States Budget, Special Analysis G and H, Fiscal Year 1990.

The federal role in financing programs and services provided by state and local governments is relatively small when compared with spending for these purposes, which is derived from revenues raised by state and local governments. Yet, federal aid is important because it often signifies strong federal interests (e.g., in health care) or because it is designed to encourage innovation or stimulate spending for particular kinds of services (e.g., in primary and secondary education). Until 1986, federal aid—in the form of general revenue sharing—also was designed to moderate differences in fiscal capacities between wealthier and poorer communities.

Some Reagan administration efforts to simplify the intergovernmental system notwithstanding, the federal relationship with states and localities has continued to grow in complexity over the past decade. The federal government's reach has been extended in ways not traditionally considered grant or grant-connected, including new actions in policy areas affected by tax subsidies, regulations, and preemptions. At the same time, the federal government has more explicitly recognized the state role in domestic policy development and administration and deemphasized its connection with local governments. These changes occurred in part because changed federalism policies and constraints imposed by a large federal deficit increased pressure for cuts in federal aid to states and localities as part of an overall effort to reduce the deficit. Yet, because actions were not part of a single plan for reforming the intergovernmental system, their aggregate impact was not explicitly considered.

Given the magnitude of change in the intergovernmental system over the past decade and the fact that the federal government depends primarily on state and local governments to achieve its domestic policy objectives, we sought to examine recent trends and changes in the relationship between federal and state and local governments in order to identify the principal challenges these trends pose for achieving national policy goals and program objectives.

Objectives, Scope, and Methodology

Our objectives were to identify trends in the intergovernmental system over the 1978-88 period and to describe their consequences with respect to issues federal policymakers are likely to face in the near future. To set the context for this analysis, we first identified nine major events affecting intergovernmental relations since 1978 (see app. I). We then analyzed key trends and identified emerging issues that the Congress should be aware of in the coming decade.

The year 1978 was selected as the baseline for measuring changes in the intergovernmental system because in this year federal aid to states and localities peaked in real terms, and because it was a turning point in public attitudes toward taxation as reflected in the passage of California's property tax limitation proposition, Proposition 13 (see app. I). These two events signaled the beginning of a fundamental redirection in intergovernmental relations, which for the two preceding decades had emphasized growth in the size and range of federal-state and federal-local programmatic partnerships. This pattern of federal expansion was reversed in the 1980s by President Reagan's policy of devolving program authority to the states as well as by the sustained fiscal pressures associated with the growing federal budget deficit.

In part, our analysis is based on a series of interviews with expert observers of the intergovernmental system, both inside and outside the federal government. In addition, we interviewed selected state and local officials in Colorado, Florida, Massachusetts, North Carolina, and Texas (see app. II). We chose these states so as to balance geographic location and size as well as political party affiliations of governors and majorities in legislatures. Our analysis is also based on an extensive review of relevant research conducted over the past decade. Finally, we drew on our earlier work on block grants and other intergovernmental programs and our recent work on intergovernmental regulatory issues (see bibliography). Interviews were conducted between March and October 1988.

Federal Budgetary Retrenchment Increased the State Role in the Intergovernmental System

Federal budgetary retrenchment increased the role of states in the intergovernmental system by reducing subsidies to local governments and increasing state authority over some kinds of federal aid. Changing priorities, tax cuts, and mounting deficits drove federal policymakers to cut budget and tax subsidies to both states and localities. These cuts fell more heavily on localities, however, because the Congress placed substantial importance on those "safety net" programs in health and welfare that help the poor, which generally are federal-state partnerships. In contrast, the Congress placed less importance on those "nonsafety" net programs in infrastructure and economic development, which generally are federal-local in nature.

The Congress also made cuts in two large federal tax subsidies affecting state and local governments: the deductions for state and local sales taxes paid by taxpayers who itemize on their federal income tax returns and the exclusion of taxpayers' interest earnings on tax exempt bonds. The deductions for sales taxes were eliminated.[1] And there were major changes in the area of tax exempt bonds, a primary source of capital for state and local infrastructure and community and economic development projects. In this respect, rules on federal tax treatment were tightened. Existing limits on the total dollar amount of private activity bonds that may be issued in a single year were lowered significantly.[2,3] And the power to allocate private-activity bond authority (within these federally imposed ceilings) was taken from local governments and given to states, increasing their authority over local public finance.

During this period of federal budgetary retrenchment, states increased their aid to local governments by nearly 24 percent (in constant dollars), although this growth did not keep pace with the growth of revenues generated from local sources. Moreover, state aid to some kinds of local governments grew more than others. Thus, for example, while state aid

[1]The benefit that states and localities received from this deduction had always been indirect, presumed to flow from an increased willingness of citizens to pay higher sales taxes at state and local levels than they would in the absence of the federal deduction. However, because estimates of this benefit depend on economic assumptions, estimates of it vary.

[2]In many, although not all, instances, private-activity bonds are used by state and local governments to provide capital for private sector enterprises and economic development projects. For federal tax purposes, tax exempt bonds are divided into three groups: (1) governmental tax exempt, (2) private activity tax exempt, and (3) private activity taxable. For a detailed discussion of the differences among these see Margaret T. Wrightson, "Intergovernmental Tax Immunity and the Constitutional Status of Federalism," Publius: The Journal of Federalism 19 (Summer, 1989), p. 40.

[3]The benefit of exclusions of interest earnings on tax exempt bonds to the state-local sector is the difference between the interest rate on taxable bonds, which these governments would pay in the absence of the exemption, and the interest they actually pay.

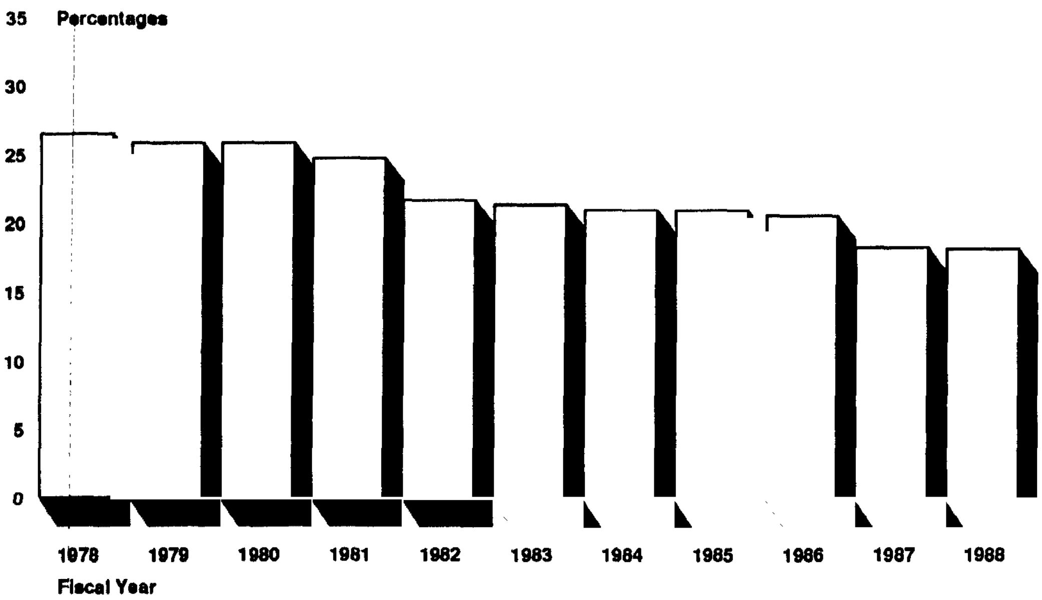
to school districts rose as a share of school district revenues, counties and especially cities became more fiscally self-reliant.

Deficit Reduction Strategies Drove Retrenchment

The 1981 tax cuts and indexation of income taxes to inflation did not cause federal revenues to decline over a 5-year period, but revenues grew more slowly in the 1980s than in the previous decade. In the absence of correspondingly large spending reductions, the slower growth in tax revenues and increased defense spending led to a dramatic growth in the budget deficit and ultimately to the adoption of the Gramm-Rudman-Hollings Act of 1985 (GRH) (see app. I).

The intergovernmental impacts of federal deficits and changing national priorities were visible well before GRH, however. Even though federal aid in the form of grants to state and local governments totalled $95 billion in 1989, this kind of aid peaked in real terms in 1978. This was also the year California's property tax limitation proposition, Proposition 13, was passed (see app. I). Thereafter, the Omnibus Budget Reconciliation Act of 1981 (OBRA) resulted in domestic spending cuts of $35 billion in fiscal year 1982. Grants to state and local governments fell $6 billion in nominal terms that year and 13 percent below anticipated or baseline expenditures. Altogether, OBRA eliminated 59 grant programs and consolidated nearly 80 narrowly focused categorical grant programs into nine broad-based block grants. Significantly, many of the grants eliminated by OBRA had been federal-local, while all of the block grants created were state-administered (see app. I). After OBRA's passage, aggregate levels of federal grants-in-aid continued to decline, but more slowly. Overall, during the 1978-88 period, federal aid to state and local governments decreased by $17.2 billion in constant dollars. As a share of state-local expenditures, federal aid shrank by about one-third, from 27 to 18 percent, as shown in figure 2.1.

Figure 2.1: Federal Grants-in-Aid as a Percentage Share of Total State-Local Spending (1978-88)

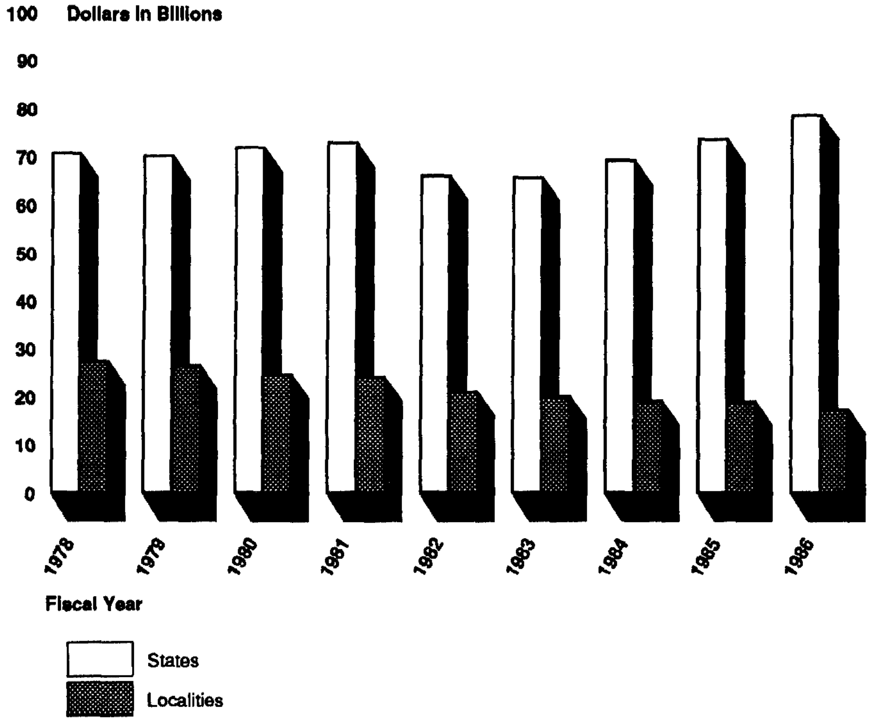


Source: ACIR, Significant Features of Fiscal Federalism, 1989 Edition, vol. I, p. 21.

Federal Aid Cuts Fell Most Heavily at the Local Level

Although total federal aid to states and local governments declined, the decline affected states and localities differently. Total aid fell at an annual rate of 1.6 percent between 1978 and 1986 in constant dollars. However, it grew at a 1.3-percent rate for states, while decreasing at a 5.5-percent rate for local governments over the same period. In effect, states were enjoying a larger share of a smaller pie, as is shown in figure 2.2.

Figure 2.2: Trends in Federal Aid to States and Localities (1978-86)
(Constant 1982 Dollars)



Source: ACIR, Significant Features of Fiscal Federalism, 1988 Edition, vol. II, p. 81.

There also were relative differences among local governmental fiscal "losers." As a Congressional Research Service (CRS) analysis found, counties were among the hardest hit, experiencing a 73-percent decrease in direct federal aid as a percentage of total revenues between 1980 and 1986 (see table 2.1). The same analysis also puts growth in state aid in clearer perspective. Moreover, while federal assistance to states increased in absolute terms between 1980 and 1986, this aid did not keep pace with state revenue raising efforts over the same period. Thus, even among the "winners," federal assistance declined by 11 percent when expressed as a proportion of total revenue, as table 2.1. shows.

Table 2.1: Percentage Decrease in Federal Aid as a Share of Total Revenues, by Type of Government (1980-86)

Type of government	Federal aid as a percentage share of total revenues 1980	1986	Percentage change
State	26.5	23.6	−11
Special districts	20.8	15.0	−28
School districts	8.9	6.1	−31
Cities	14.3	6.2	−57
Townships	7.4	2.1	−72
Counties	9.1	2.5	−73

Note: General Revenue Sharing program funding was netted out from the fiscal year 1985-86, to reflect its elimination in fiscal year 1987.

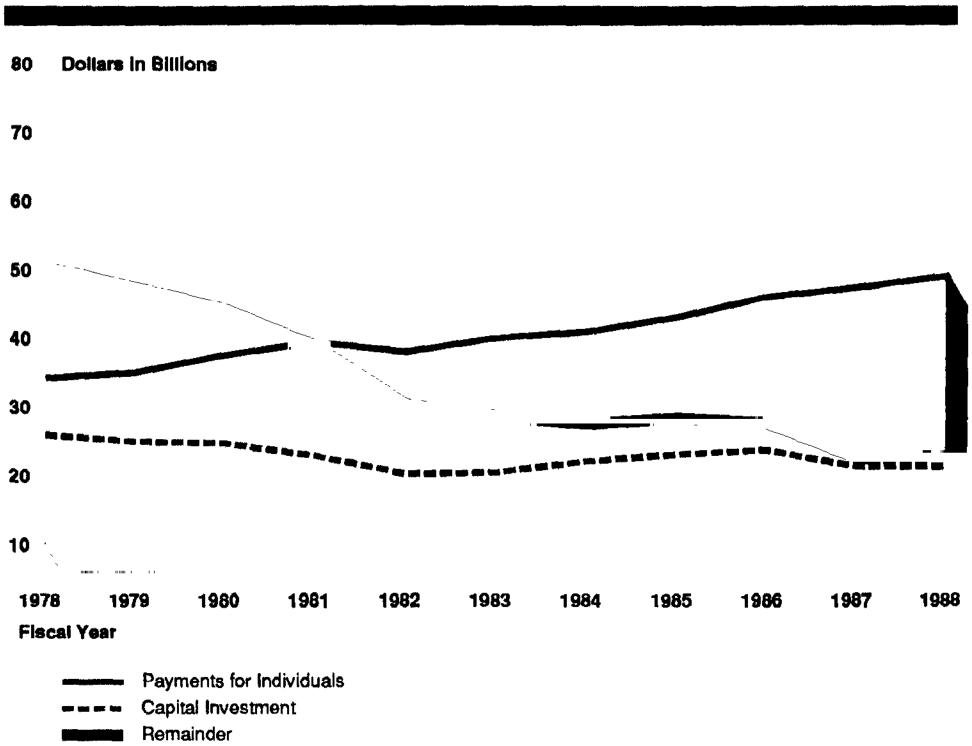
Source: Lillian Rymarowicz and Dennis Zimmerman, Federal Budget and Tax Policy and the State-Local Sector: Retrenchment in the 1980s (Congressional Research Service Report, 88-600 E, September 9, 1988.)

Types of Programs Receiving Federal Aid Have Changed

Expenditures for entitlement programs such as Medicaid, which are typically administered by states, increased over the 1978-88 period, while aid for economic development, housing, and other nonsafety net programs, which almost exclusively goes to local governments, declined. Furthermore, states assumed greater responsibilities and increased program discretion in the areas of health and welfare under newly enacted block grants (see app. I). While total 1982 program funding was cut by 15 percent below the 1981 categorical grant level under the block grants, states experienced a net increase in funds overall because many of the programs eliminated had been federal-local.

These same trends can be seen in another way. Federal aid for governmentally administered programs designed to meet the needs of individuals increased, while aid directed to governments to meet community-wide or public service needs declined. For example, Medicaid has increased every year since fiscal year 1978, a trend projected to continue. On the other hand, those forms of aid to governments that generally support capital improvements or public services were cut, resulting in the contrasting trendlines depicted in figure 2.3.

Figure 2.3: Changes in the Composition of Federal Aid to States and Localities (1978-88) (Constant 1982 Dollars)



Source: Office of Management and Budget, Historical Tables, Budget of the United States Government (fiscal year 1990), p. 240.

Two Key Tax Subsidies Were Cut

An indirect form of federal assistance to states and localities is tax subsidies, whereby the federal government forgoes collecting revenues it would otherwise receive from corporations and individuals.[4] The total of these subsidies increased during the 1978-88 period, but two large tax subsidies—the deductions for state and local taxes and the interest exemption for tax exempt bonds—were cut back. These changes reduced the rate of growth in state and local tax subsidies beginning in 1988. However, because these changes are recent their impacts are not yet entirely clear.

[4]Tax subsidies (many of which are reported in the Office of Management and Budget estimates of tax expenditures) are losses to the treasury resulting from provisions in the federal income tax code that give preferential treatment to individuals, corporations, and non-profit entities. Common preferences include differential rates for taxing different forms of income as well as deductions, credits, exclusions, and exemptions for some kinds of business and personal expenses.

Past Growth of Tax Subsidies

Tax subsidies aiding states and localities are generally of two kinds: exclusions of interest (almost entirely comprised of tax exempt bond interest) and deductions for taxes paid by individuals and corporations to state or local governments (see table 2.2).[5]

Table 2.2: Tax Expenditures Aiding State and Local Governments (Fiscal Year 1988)

(Dollars in Billions)

Description	Value
Exclusion of interest on:	
Industrial development bonds (IDB) for certain energy facilities	0.3
Pollution control/waste disposal facilities	1.6
Small issue IDBs	2.7
Mortgage bonds for owner-occupied housing	1.8
Debt for rental housing	1.2
Bonds for mass commuting vehicles	0.01
Bonds for airports, docks, etc.	0.7
Bonds for student loans	0.4
Debt for private, nonprofit education facilities	0.3
Debt for private, nonprofit health facilities	2.2
Debt for veterans housing	0.3
Debt for state/local public purpose bonds	10.4[a]
Deductibility of:	
Nonbusiness state and local taxes other than owner-occupied housing	17.3
Property taxes for owner-occupied housing	10.1

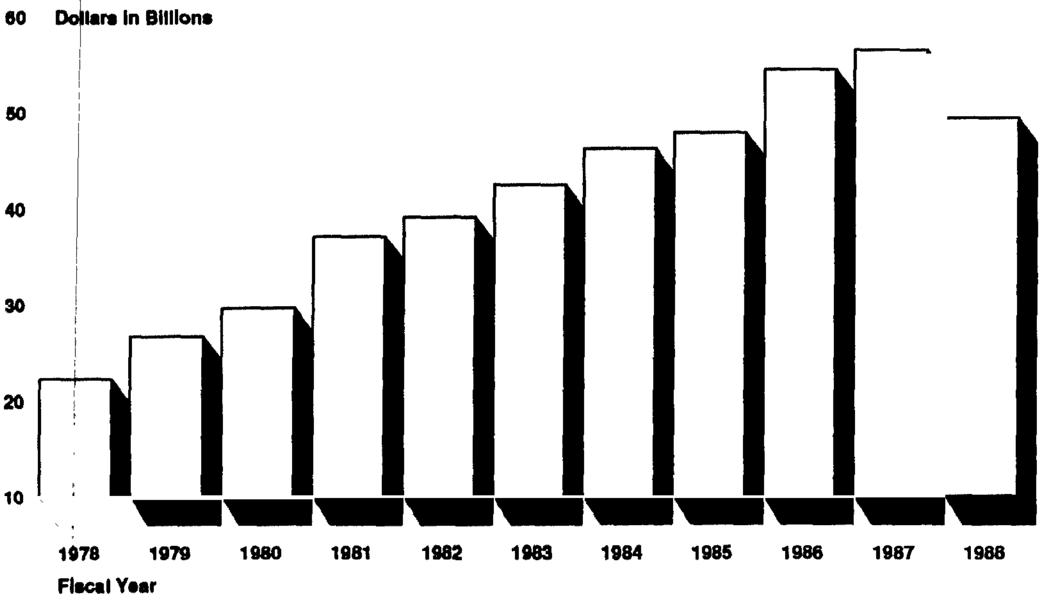
[a]The estimate of total tax expenditures reflects interactive effects among the individual items. Therefore, the individual items cannot be added to obtain a total.

Source: Office of Management and Budget, United States Budget, Special Analysis G, Fiscal Year 1990.

Tax subsidies aiding state and local governments grew rapidly over the 1978-86 period, as is shown in figure 2.4.

[5]On these points see Lillian Rymarowicz and Dennis Zimmerman, The Effect of Federal Tax and Budget Policies in the 1980s on the State-Local Sector (Congressional Research Service Report 86-2 E, January 2, 1986); Daphne A. Kenyon, "Implicit Aid to State and Local Governments Through Federal Tax Deductibility"; and Dennis Zimmerman, "The Intergovernmental Struggle Over Tax-Exempt Bond Reform" in State and Local Finance in an Era of New Federalism (Greenwich, CN, 1988), pp. 63-101.

Figure 2.4: Federal Revenues Forgone Through Subsidies Favoring State and Local Governments
(Fiscal Years 1978-88)(Dollars in Billions)



Source: Special Analysis G of the Budget of the United States, 1978-88 editions.

Sales Tax Deductions Eliminated, Tax Exempt Bonds Restricted

A large share of the recent and projected decline in tax subsidies can be attributed to the elimination of deductions for state and local sales taxes and restrictions on tax exempt bonds contained in the Tax Reform Act of 1986 (TRA-86) (see app. I).

The loss of the deduction for state sales taxes constituted the largest of cuts in tax subsidies. Because its impacts on state taxing and spending abilities are indirect, however, its consequences are difficult to determine. On the other hand, with respect to the increased role of the states, the changes in tax exempt bonds are significant for two reasons. First, much of the federal revenue loss associated with tax exempt bond growth can be traced to the vigorous use of these bonds for purposes other than traditional local and state infrastructure projects. Second, states were given greater authority to control the issuance of private-activity bonds within the limits of a single federally imposed volume cap.

By the late 1970s and early 1980s, tax exempt bonds were being used to fund many more kinds of activities than they were traditionally used for (e.g., public schools or road construction). They were being issued for a variety of loosely defined public-private partnerships, including some for business development and for construction of pollution-control, trade-show, convention, and sports facilities. Private-activity bonds also were issued to subsidize consumer borrowing, especially for low-cost college tuition loans and below-market-rate home mortgages primarily for first-time homebuyers.

As uses multiplied and volume expanded, private-activity bonds came to be regarded by federal policymakers with increased skepticism. The Congress began to restrict the use of tax exempt bonds, but with mixed success. The Revenue and Expenditure Control Act of 1968 defined industrial development bonds (IDBS) and specified the circumstances under which such bonds were to receive preferential federal tax treatment. Later, the Mortgage Subsidy Bond Tax Act of 1980, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and the Tax Reform Act of 1984 (TRA-84) commonly considered as part of the Deficit Reduction Act of 1984 (DEFRA) eliminated a number of abuses (e.g., use of proceeds from small issue IDB's to finance race tracks, variety stores, and fast food restaurants) in the area of private sector investment and consumer borrowing.)[6] However, these limitations proved not to be very effective, and bond volume continued to grow as figure 2.4 shows.

The passage of TRA-86, most noted for lowering marginal income tax rates, reversed this trend in dramatic fashion. Altogether, the act's intergovernmental impacts were considerably greater than those of other recent tax legislation, notably TEFRA and TRA-84. In addition to new provisions affecting the use of bond proceeds,[7] TRA-86 provided a single state volume cap set at $50 per capita or $150 million per annum in

[6]On these and other examples of congressional action to curb abuse see Dennis Zimmerman, "The Intergovernmental Struggle Over Tax Exempt Bond Reform," in Michael E. Bell, State and Local Finance in an Era of New Federalism, (Greenwich, CN: JAI Press, 1988), pp. 101-124.

[7]These included, for example, provisions restricting the use of bonds to encourage business investment, bonds for some kinds of public transportation projects, and the use of bonds in advanced refunding and arbitrage practices (see app. I).

1988. With limited exceptions, this cap applies to all types of private-activity bonds.[8]

States Step In, Providing More Aid to Local Governments

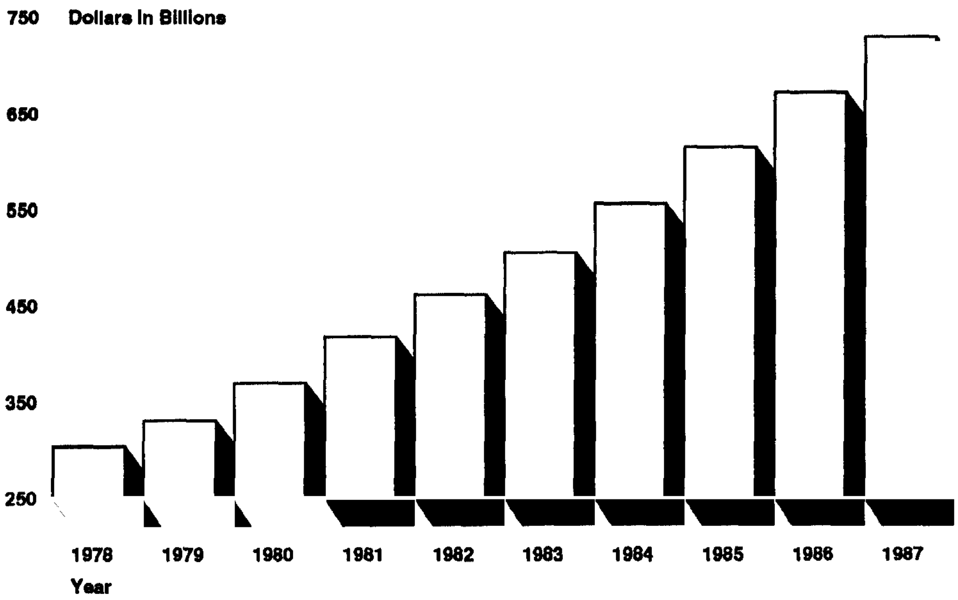
As the federal government became a less dependable source of local government financial assistance, expectations about the role of the states in domestic policy shifted. The fact that states moved to replace some lost federal grant funds to local governments contributed to a widespread sense among observers of the intergovernmental system that states were "on the move." In fact, state aid to cities increased 2.5 percent in real terms between 1978 and 1986. State aid to counties increased 15.5 percent over this same period.

Notwithstanding this increase, however, state aid did not keep pace with local revenue raising. During this same 7-year period, general revenues derived from local sources increased 37 percent for cities and 52 percent for counties. On average, cities received about 36 cents from state government for every dollar raised in 1979. But, by 1986, this figure was only 29 cents. In 1979, counties received 69 cents, but by 1986 they received less than 51 cents. An important exception to this trend was school districts. In 1978, they counted on the state for 97 cents for every dollar they raised from their own sources, but by 1986 this figure had risen above $1.17. Altogether, state-local revenues (exclusive of federal aid) grew substantially over the decade we examined, as figure 2.5. shows.

[8]The impacts of TRA-86 on states were not entirely negative. In particular, the passage of federal income tax reform laws provided a potential windfall of tax revenues to the states that coupled their income tax systems to the federal tax system. To the extent that these states left their own income tax systems untouched, the elimination of tax preferences from federal income tax would also eliminate them as preferences for purposes of determining state income tax liability. Thus, for example, ACIR estimated that federal income tax reform would create a windfall in tax revenues of over 18 percent in six states. At the other end of the spectrum, ACIR estimated that 14 states would receive a windfall of less than 5 percent of total revenues from individual income tax increases. Altogether, state tax liabilities after federal tax reform were estimated to increase $5.2 billion by ACIR. In fact, states have begun to modify their income tax systems in the aftermath of TRA-86, in some cases returning a large share of revenues to taxpayers. Because modifications are recent, however, their impact is not yet fully known.

ACIR also found that, in the absence of states modifying their income tax systems, federal income tax reform would produce a tax shortfall in some states. ACIR estimated that 15 states would lose tax revenues as a result of TRA-86, ranging from 12 percent in North Dakota to less than 1 percent in South Carolina. On all these points see ACIR, The Tax Reform Act of 1986—Its Effect on Both Federal and State Personal Income Tax Liabilities, SR-8, January, 1988; and ACIR, Preliminary Estimates of the Effect of the 1986 Federal Tax Reform Act on State Personal Income Tax Liabilities, December 8, 1986.

Figure 2.5: Growth in State-Local Revenues, Excluding Federal Aid (1978-87)



Source: ACIR, Significant Features of Fiscal Federalism, 1989 Edition, vol. I, p. 13.

Our examination of trends in state aid to local governments during this period showed that states were most apt to make up losses of federal-local aid in programs that already were within their traditional domains or in which they previously had made significant financial or political commitments. Moreover, the replacement of federal aid and the growth of state and local revenues were often linked to the strength of state and local economies. For example, in Massachusetts, where the economy was strong during most of the past decade, local governments looked to the state for increased assistance when federal revenue sharing funds lapsed, and the state responded in 1987, partially offsetting the loss with state funds. However, 2 years later, when Massachusetts experienced a budget crisis, this aid was cut substantially.

Communities in states that were economically depressed during the past decade were less fortunate. For example, Texas made no effort to compensate local communities when federal revenue sharing was terminated. While the loss of these funds was only one contributing factor, in 1987, fiscal pressure forced 58 percent of Texas cities to raise user fees, 47 percent to postpone planned capital construction projects, 45 percent to raise property taxes, 15 percent to lay off employees, and 10 percent to reduce services. Nearly 57 percent of these communities collected less revenue in 1987 than projected, and 43 percent anticipated even lower revenues in 1988. As would be expected, the most common strategy for coping with fiscal problems was to defer capital projects, including those required to maintain current service levels. So much so that, by one estimate, in 1987 Texas had an $8 billion backlog of such projects with an additional $8 billion projected by 1992.[9]

[9]Texas Municipal League, "Capital Spending in Texas Cities," August 8, 1988.

Trends in Federal Regulation Lessened State Discretion but Not Responsibility

Federal budget cuts broadened the role of the states in the intergovernmental system. In contrast, trends in federal regulatory activities over the past decade lessened state discretion without reducing state responsibility. By the late 1970s, the growth of intergovernmental regulation had increased fiscal tensions between federal and state and local governments significantly. An important part of the Reagan administration strategy to reduce the federal role in the intergovernmental system was to limit regulation of state and local governments as well as the private sector. Anticipating a reduction in regulatory relationships, the administration also deemphasized intergovernmental grants and traditional grant management techniques designed to create intergovernmental cooperation and consultation. Yet the effectiveness of administration efforts was negated by increased state and local responsibilities stemming from added program standards and administrative requirements created during the 1980s and by reduced levels of federal aid for state and local oversight and administration of regulatory programs. Coupled with new federal preemptions of state authority in some policy areas, the overall pattern has been more federal involvement with less financial support.

Past Growth and New Forms of Intergovernmental Regulation

Since the passage of the first annual cash grant to states under the Hatch Act of 1887, the federal government has regulated various state and local government activities by attaching program and administrative requirements as conditions of intergovernmental aid. The rapid expansion of grants and grant requirements in the 1960s and 1970s led every president since Lyndon Johnson to make efforts to improve the management of this system. Meanwhile, other kinds of regulatory relationships blossomed during the 1960s and 1970s and gained attention.[1] In particular, as part of its own stepped-up agenda of social regulation,[2] the federal government enlisted state and local governments in national efforts on behalf of particular disadvantaged groups or to advance policies, such as environmental protection. In addition to the use of program and administrative regulations issued as direct or indirect conditions of

[1]See ACIR, Regulatory Federalism: Policy, Process, Impact and Reform (Washington, D.C.: U.S. Government Printing Office, February, 1984).

[2]As noted in George C. Eads and Michael Fix, Relief or Reform? Reagan's Regulatory Dilemma (Washington, D.C.: Urban Institute, 1984), p. 12, the term "social regulation" is widely applied to the set of federal programs that "use regulatory techniques to achieve broad social goals such as a cleaner environment, equal employment opportunity, or safer and more healthful workplaces." In contrast, "economic regulation" refers to programs that "attempt to control prices, conditions of market entry and exit, and conditions of service," usually in particular industries where activities affect the public interest. Nearly all social regulatory programs involve a partnership between national and state or local governments, while programs of economic regulation generally do not.

aid, other devices used during the past decade have included preemptions, in which federal policies and standards supercede state and local ones, and direct orders, in which the national government directly orders states and local governments to take certain courses of action.[3]

Reagan Administration Efforts to Decentralize and Simplify Federal Regulation

The Reagan administration attempted to slow the growth of social regulation and reduce regulation of states and localities and the private sector. Upon taking office in 1981, the administration froze all pending rulemakings, and the President created a task force on regulatory relief to eliminate or modify the most burdensome regulations. Finally, presidential review of agency rulemaking was strengthened in 1981, and mechanisms for the Office of Management and Budget (OMB) involvement in agency regulatory planning were instituted in 1985, both by executive order.[4] These undertakings applied equally to all executive branch rulemaking activities, including those affecting state and local governments.

With respect to regulation affecting states and localities in particular, the Reagan administration was the first in recent years to make systematic efforts to reduce the number of regulations and their costs. Among other administration actions, the Presidential Task Force on Regulatory Relief canvassed state and local governments specifically, generating a long list of regulations these groups perceived to be onerous. Eventually, 24 actions were taken to reduce state and local burdens. According to White House estimates, these saved $4-6 billion in total investment costs and $2 billion in annually recurring costs.

The administration also directed agencies to examine the intergovernmental impacts of proposed regulations in 1981, as part of its general guidance on agency rulemaking. In the case of the OBRA block grants, the administration worked to minimize the regulations attached to these, reducing some 600 pages of program rules and regulations under the

[3]ACIR's typology of intergovernmental regulations includes full and partial preemptions, direct orders, indirect conditions of aid comprised of crosscutting and crossover regulations, and direct conditions of aid. For our analysis we grouped partial and full preemptions under the heading of preemptions and direct and indirect regulations under the heading of regulatory requirements. These techniques are described in detail in ACIR, Regulatory Federalism: Policy, Process, Impact and Reform (Washington, D.C.: U.S. Government Printing Office, February, 1984), ch. 1.

[4]In 1981 Executive Order 12291 was issued, creating a system of presidential oversight of agency rulemaking. In 1985, Executive Order 12498 was issued, creating a system of presidential oversight of agency regulatory planning. For a description of these two programs see Marshall Goodman and Margaret Wrightson, Managing Regulatory Reform: The Reagan Strategy and Its Impact, (New York: Praeger Publishers, 1987), pp. 38-46.

folded-in categorical grants to less than 10. In 1985, the White House renewed its review of existing rules, this time working directly with the National Governors' Association (NGA) to identify burdensome regulations and revise them.

At the same time, the administration deemphasized traditional intergovernmental management mechanisms (e.g., intergovernmental review and consultation procedures for coordinating grant programs), especially at OMB. Thus, in 1981, the Intergovernmental Affairs Division of OMB had 21 staff members. By 1984, this division was eliminated and its responsibilities divided among other OMB offices. The Administration also stopped work on a proposed OMB circular to manage so-called crosscutting regulations that apply to all federal grants-in-aid. Moreover, it rescinded OMB Circular A-95, which provided for intergovernmental advance notice and comment on intergovernmental grant and regulatory programs. This circular was replaced with a decentralized process of review and comment, to be managed by the states. Finally, the administration made staff cuts in intergovernmental affairs' offices across executive branch agencies.

In retrospect, the administration was unable to reduce significantly the number of regulations affecting state and local governments or to substantially simplify regulatory programs. Thus, while the statutory objectives governing the regulatory system remained largely unchanged, the mechanisms for intergovernmental cooperation in the management of this system were reduced as a result of administration actions.

Regulation Increased, Funding Was Cut

Notwithstanding these administration efforts to reduce regulation of state and local governments, intergovernmental regulation increased over the past decade, but the growth of regulatory requirements and preemptions was most notable. Conversely, funding for state and local government administration and oversight of regulatory programs was reduced.

Regulatory Requirements Increased

In a review of 18 major areas of regulation affecting state and local governments, we found that the number of regulations increased in most of these areas between 1981 and 1986. Other studies of intergovernmental regulation have come to similar conclusions and also pointed to the often prescriptive character of the new rules and requirements. Overall, state and local governments became subject to hundreds of new program standards and administrative requirements. Thus, during the period we examined, states became subject to federal mandates in a wide variety of areas, including education, construction projects, health and safety, aged and handicapped rights, and penal institutions. The following are examples of changes affecting state and local governments.

- Clean Water: municipalities are now required to monitor "nonpoint" pollution from thousands of storm sewers and to implement testing for 77 additional chemicals in municipal water supplies. In 1986, the Congress added 83 new drinking water contaminants to be controlled by local governments under the Safe Drinking Water Amendment of 1986.
- Education: school districts were required to identify asbestos hazards and then to remove them from local schools.
- Clean Air: the Congress modified requirements in the Clean Air Amendments of 1977. In response to these amendments and court decisions, the Environmental Protection Agency (EPA) reinstated emission standards for asbestos control in 1984 in the areas of provisions for spraying, fabricating, and insulating materials as well as for demolition and renovation.
- Endangered Species: 152 new species were added to the endangered and threatened lists. These additions required states to prepare status reports on each newly added species and also assigned states monitoring and enforcement responsibilities for protecting these species.
- Consumer Safety: the Department of Agriculture (USDA) created new requirements affecting the entry of packaging materials to meat processing plants across the entire meat processing industry. Also new procedures for inspection, tagging, and retention of cattle and for inspecting for contaminants were created. These affected states because under title III of the 1967 Wholesome Meat Act states have inspection and enforcement responsibilities.
- Occupational Health and Safety: state monitoring and enforcement responsibilities were affected by Occupational Safety and Health Administration actions requiring businesses and industries to establish and maintain hearing conservation programs, ethylene oxide exposure protection and asbestos protection programs, standards for the use of electricity at construction sites, and a safety program for organizations that respond to environmentally hazardous situations.
- Transportation: after much controversy, in 1984 President Reagan signed legislation that required states to adopt a minimum drinking age for alcohol of 21 years old or face reductions of 10 percent in federal highway aid in 1987.

At the same time, federal funding for administration and oversight in many of the areas of social regulation declined. Federal grants for administration and oversight in some areas, such as bilingual education and clean air programs, declined by nearly 37 percent in constant dollars between 1978 and 1988, as shown in table 3.1.

Table 3.1: Administration and Oversight Budgets, Selected Intergovernmental Regulatory Programs (Fiscal Years 1978-88) (Constant 1982 Dollars)

	1978	1988	1978-1988 Percentage change
Handicapped education	$645,788	$1,159,269	79.5
Safe drinking water	37,975	56,431	48.6
Clean air	93,108	125,384	34.7
Occupational safety and health	195,129	182,920	−6.3
Bilingual education	189,565	112,792	−40.5
Surface mining	115,162	62,163	−46.0
Clean water (total)	4,578,094	2,085,645	−54.4
Direct assistance	4,482,173	1,964,423	−56.2

[a]For any given year, totals may vary due to change in the number of state administering programs.
Source: Office of Management and Budget, United States Budget.

Preemptions Increased

The Congress has broad authority through, for example, the commerce and supremacy clauses of the Constitution, to preempt state and local laws and ordinances. Traditionally, this authority has been applied to areas of economic regulation, although examples of preemption in social policy areas may also be found. In the category of economic preemptions, the Airline Deregulation Act of 1978 stipulated that state and local governments may not regulate the routes, rates, or services of air carriers. The Motor Carrier Act of 1980, which deregulated the trucking industry, and the Bus Regulatory Reform Act of 1982, which deregulated the busing industry, contained similar preemptions. ACIR examined trends in preemption statutes and found that in every area except banking and civil rights federal preemption was on the rise in the 1980s, as table 3.2 shows.

Table 3.2: Federal Preemption Statutes, by Date of Enactment

Date	Civil rights	Money	Business	Health and safety	Other	Total
Before 1900	4	•	9	1	•	14
1900-1909	•	•	6	3	•	9
1910-1919	•	1	8	3	3	15
1920-1929	•	1	8	4	•	13
1930-1939	•	8	27	2	4	41
1940-1949	•	1	8	4	1	14
1950-1959	1	3	11	3	1	19
1960-1969	8	3	8	19	1	39
1970-1979	13	15	20	45	2	95
1980-1988	8	8	22	50	3	91
Total	**34**	**40**	**127**	**134**	**15**	**350**

Source: ACIR, Federal Preemption of State and Local Authority (Washington, D.C.: ACIR draft document, May 1989, Appendix A, Inventory of Federal Preemption Statutes).

Direct Orders Increased

Direct orders issued by the federal government must be complied with by state or local governments or both under threat of civil or criminal penalties. While these kinds of direct orders are not common, over the past decade the federal government has issued new ones. For example, in 1979, the Department of Labor extended Fair Labor Standards Act regulations to state and local government employees. In 1985, these regulations were upheld by the Supreme Court in Garcia v. San Antonio Metropolitan Transit Authority (see app. I).

Increased State Prominence in Domestic Affairs: Progress and Prospects

Intergovernmental relations have changed significantly over the past decade as states increased their prominence in domestic affairs. The states have progressed from a period in which they were sometimes dismissed as mere administrative agents of the federal government to a period in which they are touted as key innovators. They stand on the threshold of the 1990s as highly visible leaders in a broad range of policy areas where the federal government was once seen as peerless.

There are a number of reasons for this transformation. First, states improved their capacities by modernizing their institutions and administrations and strengthening their revenue systems. Second, federal budget cuts, tax cuts, and block grants accelerated the rising role of state government in domestic policy in contrast to federal retrenchment. Finally, beginning in 1983, sustained economic growth helped to rebuild state treasuries, providing revenues to fund new initiatives.

State Agendas Are Broader and Programs More Innovative

During the past decade, states broadened their agendas and addressed their social and economic needs in innovative ways. Not all state actions have been uniform. However, many states have been active, and state leadership is now widely recognized and reported. Examples of such leadership include the following, from both traditional and nontraditional state functions.

- International Trade: State delegations, often headed by governors, now routinely travel to meet with foreign business leaders to secure new markets and solicit investment. Not all such efforts are ad hoc. By a recent NGA count, 41 states maintained offices in 24 countries worldwide. In fact, by 1989, there were more state offices in Japan (39) than there were in Washington, D.C. (38).
- The Environment: At least 29 states have implemented their own Superfund programs and others have created commissions, such as the Chesapeake Bay Commission, to protect and restore the environment.
- Housing: States, such as Massachusetts, have established a trust fund, creating a pool of capital for low- and moderate-income housing. Others, including New York, have formed public-private partnerships to achieve these same ends.
- Economic Development: Texas has created a Department of Commerce to encourage and coordinate efforts among both public and private institutions with a stake in Texas' economy. To combat urban economic decline, Pennsylvania has created a regional consortium of labor-management committees to improve cooperation, heighten labor's role in

industry decision making, and increase productivity. Michigan has created a public venture-capital fund; using 5 percent of the state's public pension funds, this development fund promotes new business and economic enterprises. Arkansas has experimented with a development bank in its efforts to counter rural economic decline. Altogether, 13 states have venture- capital programs, 30 have established business loan funds, and 31 have created research grant programs to encourage economic development.

- Growth Management: Florida has enacted legislation aimed at ensuring that adequate infrastructure exists to meet the demands of rapidly growing communities.
- Health Care: Arizona is experimenting with the use of health maintenance organizations to provide quality health care to the poor under the Medicaid program, while also holding down health care costs.
- Education: States across the nation and especially in the South have taken measures to improve their primary and secondary systems. They are raising performance standards; allocating more funds; reducing fiscal disparities; and establishing new modes of delivery, such as expanded parental choice and specialized curricula.

Improved State Capacities Contributed to State Prominence

This record of state action was in large part made possible by a much longer history of improving state governmental capacities. Since World War II, states have made substantial progress in modernizing their institutions and administrative procedures and they have improved their revenue systems. Among other things, these improvements helped state revenues remain fairly stable over the past decade, holding a constant share of overall economic activity. At the same time, state spending increased and expenditure patterns changed. In part, these differences reflect changing state priorities. But they also reflect shifts in national policy and federal court actions.

States Modernized Their Institutions and Administration

Having surveyed the administrative, fiscal, and political condition of the states, in 1985, ACIR concluded that they had been "transformed" over the previous 25 years. According to the commission, an examination of state "constitutions, legislatures, governors, executive organization structures, courts, personnel, budgeting, financing, and financial administration and openness all attest to this." In particular, four-fifths of all constitutions were revised between the mid-1950s and 1977. By 1986, state policymaking was more centralized in the governor's office because 37 states created cabinets and because many reduced the number of elected state administrative officials. State administrators are better educated, with 61 percent holding graduate degrees in 1984, compared with 40 percent 20 years ago. ACIR evaluated state legislatures against 73 recommendations made by the Citizens' Conference on State Legislatures in 1970 to improve functionality, accountability, representativeness, and independence. Thirty-eight of 43 recommendations for which assessments existed had been adopted by a majority of state legislatures. Finally, courts in almost all states underwent changes to improve the quality of judges, administration, and structure.[1]

States Improved Their Revenue Systems

Along with modernizing governmental institutions and administrative processes, nearly all states improved their revenue systems, sometimes substantially. In addition to reflecting state-based initiatives, these changes also may be seen as a response to factors outside the immediate purview of state government, notably the tax revolt of the late 1970s, back-to-back national recessions in the early 1980s, a 16-percent decline in federal grants-in-aid, and the passage of federal tax reform in 1986 (see app. I). Overall, during the past decade two general trends in revenues can be identified: a diversification and balancing of state revenue systems and a mixture of tax increases and decreases producing little, if any, net change in total revenues as a percentage of personal income.

Balancing State Revenue Systems

Since 1961, many states have turned to new kinds of taxes, as shown in table 4.1. Such diversification is viewed as one way to strengthen tax systems because governments become less reliant on any one source of tax revenue.

[1] ACIR, The Questions of State Government Capability, A-98 (Washington, D.C., U.S. Government Printing Office, 1985).

Table 4.1: Adoption of Major Taxes Since 1961

Tax	Additional states levying tax[a]	Total
Personal income	11	**40**
Corporation income[b]	9	**44**
Sales	10	**45**
Gasoline	0	**50**
Cigarettes	3	**50**
Distilled spirits[c]	0	**33**

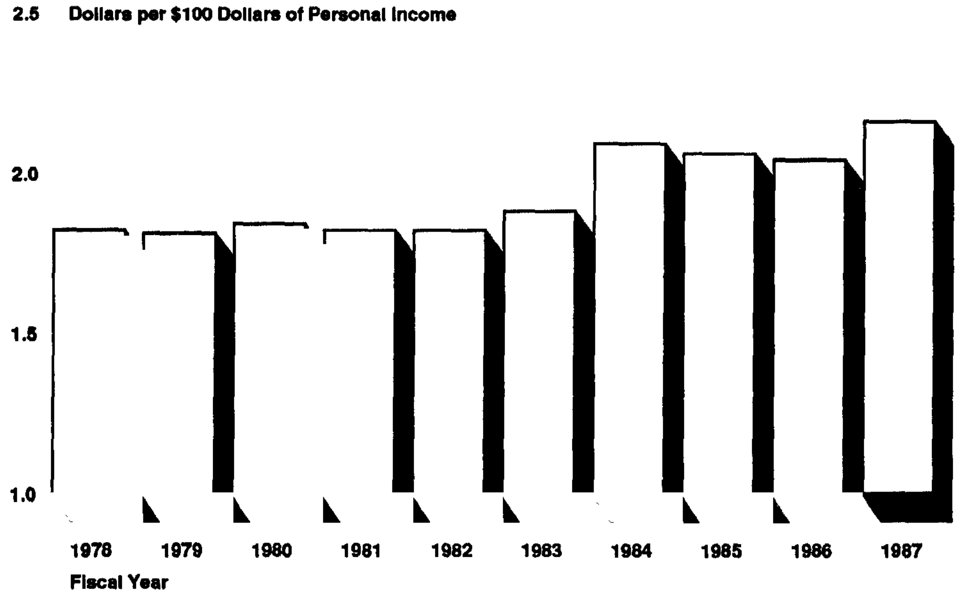
[a]Three additional states levy a tax on capital gains, interest, and/or dividends only. Alaska repealed its income tax in 1979.

[b]Michigan repealed its corporate income tax in 1976 and replaced it with a single business tax.

[c]Exclusive of the excises by the 16 states that own and operate liquor stores, and exclusive of North Carolina where county stores operate under state supervision.
Source: ACIR, Significant Features of Fiscal Federalism, 1988 Edition.

An important consequence of this activity was that personal income taxes—which are regarded as the most progressive—now comprise a larger share of total tax revenues than was true historically. In 1987, these taxes were $2.16 per $100 of personal income whereas in 1978, they were $1.82, as figure 4.1 shows.

Figure 4.1: State Personal Income Tax Revenues Per $100 of Personal Income (1978-87)



Source: Steven D. Gold, State Finances in the New Era of Fiscal Federalism, National Conference of State Legislatures, March, 1989.

During the past decade states have also turned to nontax sources as alternatives to raising tax revenues. These included user fees, lotteries, special assessments, and increased interest earnings from improved cash management. As a result, in 1986, nontax revenues comprised a larger share of state-local own source revenue than was true in 1978. In fact, between 1975 and 1986, these revenues rose from 3.5 to 4.7 percent of personal income.

Reforming Income Taxes

Not only did states diversify their revenue systems over the 1978-88 period, they also took steps to reform their income tax systems. As of 1987, the combination of federal tax reform and the recommendations of state tax commissions had produced what one observer called a "blizzard" of actions, ranging from modest changes in tax rates and base-broadening to wholesale restructuring. Such reforms have:

- made state income taxes more progressive by removing many working poor from state tax rolls,

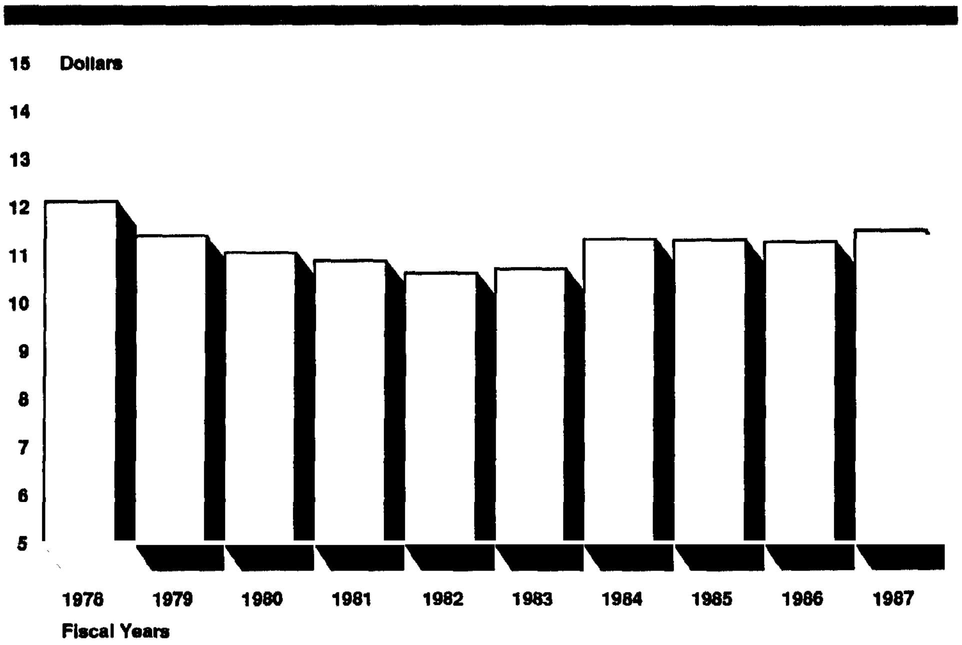
- simplified state income taxes by increasing conformity with federal provisions and by eliminating many taxpayers from the roles or the ranks of itemizers,
- provided for more equal treatment of taxpayers with similar incomes, and
- improved the competitiveness of state tax systems through rate reductions in the highest tax states.[2]

Revenues Remained Constant

Diversification of state revenue systems and income tax reform did not cause the state-local sector to increase its share of overall state economic activity during the past decade. Instead, total revenues held their own at about 14 percent of personal income in 1986. Constancy was the norm because while nontax revenues increased, tax revenues declined. In particular, in 1978—the year Proposition 13 was passed—state-local tax revenue was $12.08 per $100 dollars of personal income (see fig. 4.2.). But, during the next 5 years—a period in which the political impacts of the tax revolt became apparent and in which two national recessions occurred—the level of these same revenues dropped to $10.59 by 1982. Thereafter, revenues rebounded, in part due to temporary tax hikes and in part to sustained economic growth since 1983. As a result of these factors, by 1987, tax revenues had made up about one-half of their earlier decline, as figure 4.2 shows.

[2]Steven D. Gold, "The Blizzard of 1987: A Year of Tax Reform Activity in the States," Publius 18 (Summer, 1988), pp. 17-35.

Figure 4.2: State and Local Tax Revenue Per $100 of Personal Income (1978-87)



Source: Steven D. Gold, State Finances in the New Era of Fiscal Federalism, National Conference of State Legislatures, March 1989.

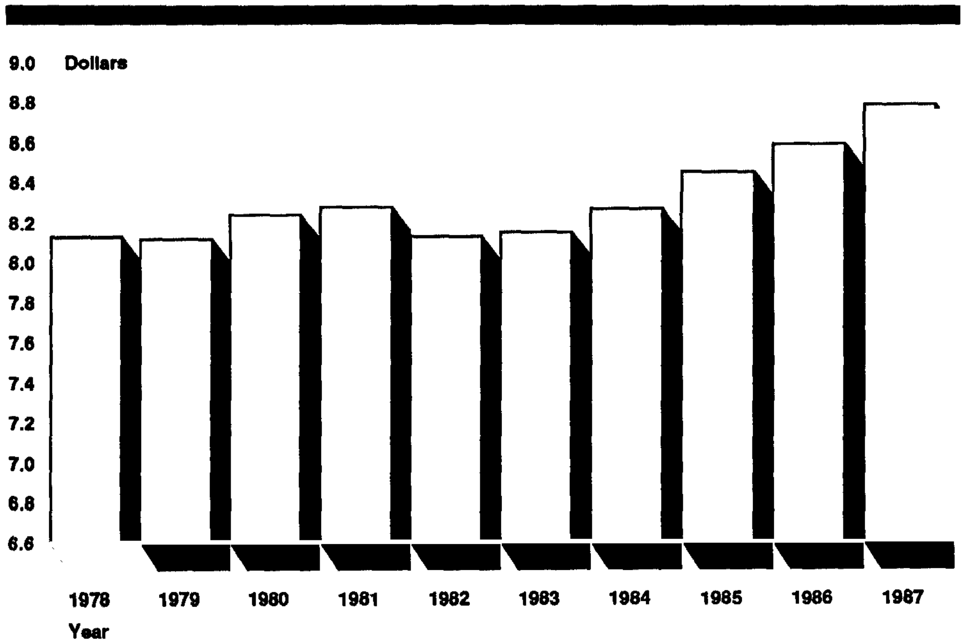
Not all states and communities participated to the same extent in the national economic recovery. As a result, aggregate revenue patterns described in this chapter can mask important differences among states and communities, with some governments enjoying substantial increases and others experiencing very little. These differences notwithstanding, with respect to changes in state revenue systems overall, the past decade has been one in which states have moved away from a strategy of "putting their eggs in one basket." In so doing, they strengthened their revenue systems by lessening dependence on any one source of tax revenue and by exploiting more sources of nontax revenue. At the same time, while state and local tax and nontax revenues (as a percentage of personal income) increased during the most recent 5-year period, these increases have not yet returned revenues to their 1978 levels when expressed as a proportion of overall economic activity.

State Spending Patterns Changed

State spending followed a path similar to that of state revenues, although, by 1987, spending had slightly exceeded the rate of economic growth over the period. Exclusive of federal aid, state spending was

$8.12 per $100 of personal income in 1978, compared with $8.77 in 1987, as figure 4.3 shows.

Figure 4.3: State Spending Per $100 of Personal Income, Excluding Federal Aid (1978-87)



Source: Steven D. Gold, State Finances in the New Era of Fiscal Federalism, National Conference of State Legislatures, March, 1989.

Examining differences within categories of spending, the overall increase in the decade is the product of large gains in two categories of spending, Medicaid and corrections. In 1978, states spent 38 cents per $100 of personal income to meet their share of Medicaid costs. In 1987, this same figure was 58 cents. Similarly, in 1978, states spent 21 cents per $100 of personal income for criminal justice and law enforcement, in 1987, they spent 33 cents. Much of this growth can be explained by factors outside the purview of states. With respect to Medicaid, for example, high rates of inflation were at work as well as federally mandated changes in eligibility and coverage. With respect to criminal justice and law enforcement, fast-paced growth is the product of more stringent state sentencing policies, but also of federal court mandates to relieve inmate crowding and improve prison conditions.

In summary, the relative stability of overall state spending obscures the more uneven pattern across areas of state budgets. Some of these differences reflect state priority setting, as in the case of education. But they also reflect changes in outside factors, principally economic cycles and federal policy actions. Lastly, state spending trends should be viewed with some caution. Variations exist among states. And, as experts we interviewed noted, spending is not the only way states affect domestic policies. Indeed, many of the innovations described in this chapter illustrate the impacts that can be made from improvements in management or changes in the manner in which services are delivered.

National Policy Directions Contributed to State Prominence

Improved state institutional and administrative capacity was not the only factor contributing to the rising role of the states in the intergovernmental system. Two national policy trends accelerated this process. First, cuts in federal aid and reduced tax revenues limited the federal government's ability to undertake new initiatives or to maintain federal commitments in existing ones (see app. I). Second, and equally important, was the Reagan administration's philosophy of greatly increasing the states' role in the intergovernmental system. This philosophy was put into action through a few highly publicized initiatives—notably block grants and regulatory relief—as well as through a number of less visible administrative measures.

Block Grants

An important step taken by the Reagan administration was its initiation of the block grants created in the Omnibus Budget Reconciliation Act of 1981. Although block grants comprised only about 10.5 percent of total intergovernmental aid in fiscal year 1989, they give greater program authority and responsibility to states. At the time OBRA was passed, there were concerns about the abilities of states to implement these programs prudently. However, to a great extent, the states were able to rely on existing state systems for management of the block grants. And subsequent studies of the implementation of these programs, including ours, have been generally favorable.

Regulatory Relief

A second Reagan administration effort was to reduce regulatory burden on states and localities as described more fully in chapter 3 of this report. In this area, intergovernmental initiatives were part of a larger administration effort to reduce social regulation through greater presidential oversight of rulemaking. Among other actions, the administration created a task force to identify and revise a number of the most burdensome federal regulations. In particular, the administration responded positively to an effort by the nation's governors to bring what they perceived as meddlesome regulations to the federal government's attention. The President created a process of presidential oversight of proposed and planned executive branch agency regulations, including those that affect state and local governments.

As chapter 3 also showed, the results of these efforts were mixed; in some cases relief was achieved, especially where there was agreement between the administration and state and local officials about appropriate courses of action. This included, for example, speeding delegation of authority to states in many environmental programs. In other cases, efforts failed to bring relief, especially where there was disagreement between levels of government or substantial opposition from other interested groups.

Other Administrative Means

Finally, there was a series of less visible executive actions that were designed to change the tone of the relationship between state and federal governments. In 1983, the President issued Executive Order 12372 requiring federal agencies to make efforts to accommodate state and local government recommendations concerning federal programs in their jurisdictions. This order, which revoked OMB Circular A-95, effectively shifted the loci of review for some 100,000 grant applications to the states by encouraging states to develop their own procedures and priorities with respect to federal financial assistance, and requiring federal agencies to defer to them whenever possible. Likewise, in 1988, the basic circular for management of grants to states and localities, OMB Circular A-102, was revised to require agency reliance on state systems and procedures for monitoring grants.

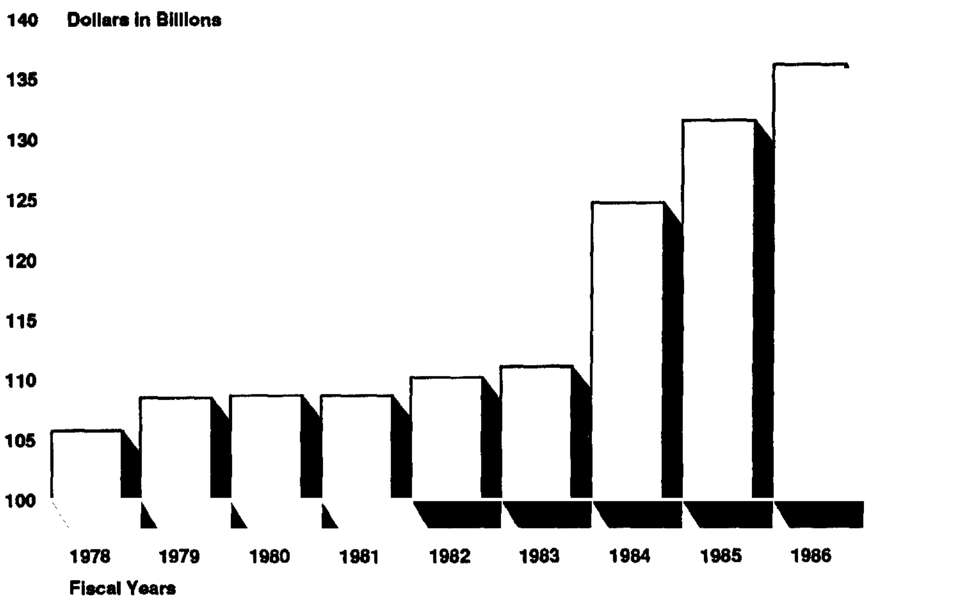
In addition, in 1987, the President issued Executive Order 12612. It requires all federal agencies, among other things, to determine when a proposed policy has implications for states and localities and to prepare a federal assessment discussing such implications where they are significant.

National and State Economic Recovery Contributed to State Prominence

Like improved state capacity and shifts in national policy directions, national and state economic recovery from the 1982 recession contributed to the increasing role of states in the intergovernmental system. Sustained economic growth has provided state and local governments with important flexibility. The resulting rise in state revenues was a key factor driving increased state spending. In fact, it allowed a number of states to reduce taxes without decreasing spending.

While states diversified their revenue bases over the 1978-88 period, they remain highly dependent on sales and income taxes, sources that fluctuate with the economy. In 1986, income and sales taxes comprised nearly 87 percent of all state own-source revenue. Because most states balance their yearly operating budgets, economic cycles have significant short-run effects. As figure 4.4 suggests, during the past decade many states experienced generally flat sales and income tax collections in the aftermath of the 1982 recession.

Figure 4.4: State Income and General Sales Tax Revenues (Fiscal Years 1978-86) (Constant 1982 Dollars)



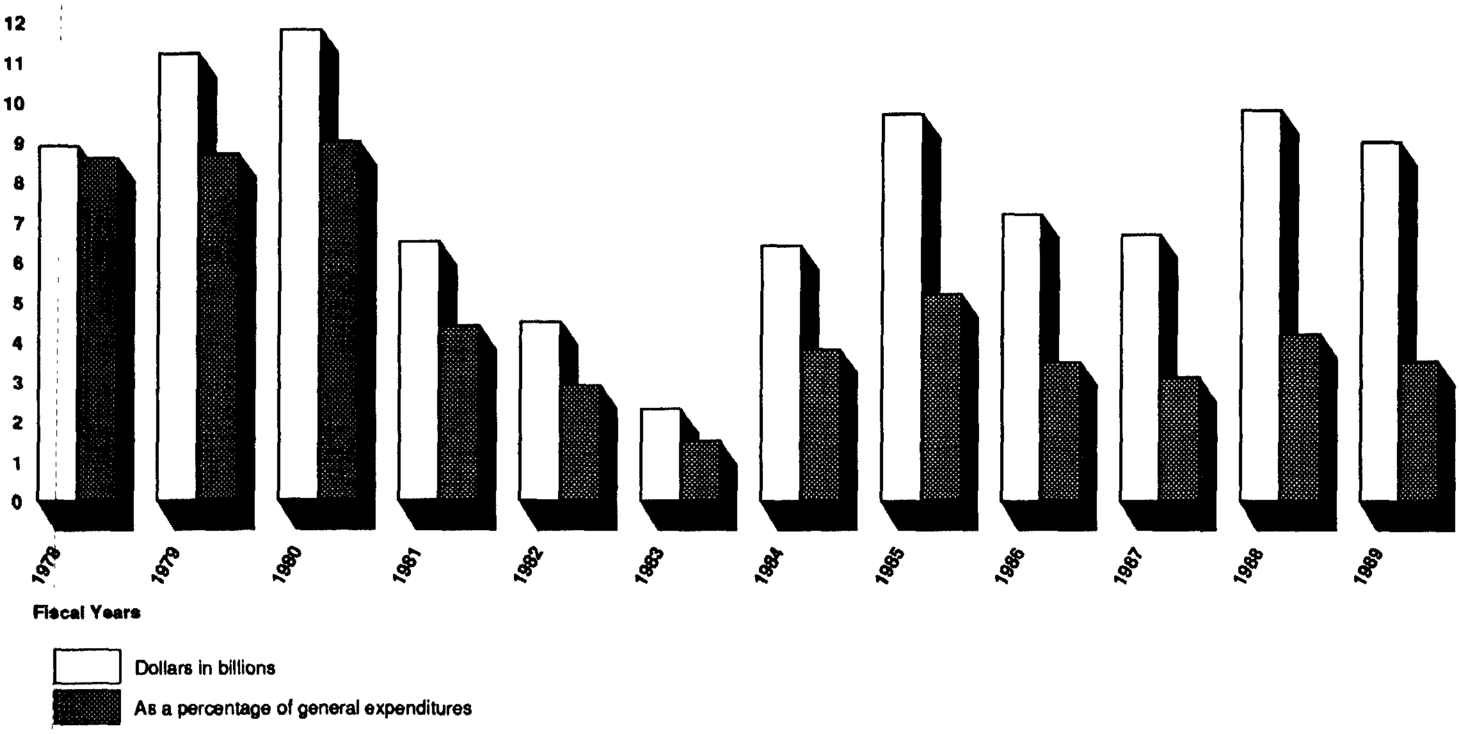
Source: ACIR, Significant Features of Fiscal Federalism, 1988 Edition, vol. II, p. 60.

For example, sales tax receipts were generally flat from fiscal years 1978 to 1984. The impact of this was immediately reflected in state budgeting. In fiscal year 1982, 25 states cut budgets after enacting them.

In fiscal year 1983, 39 states did so. State Policy Reports, a publication monitoring state governmental fiscal policies, recently estimated that states' receipts would have decreased by $11 billion if a mild recession were to have occurred in 1989, and by $22 billion in a severe recession.

States have attempted to protect themselves from the slower revenue growth that would likely result from a recession by creating special reserve funds. While 29 states have established such stabilization or "rainy-day" funds that could be used if a recession or other event caused state revenues to decline, reserves are not sufficient to weather an economic downturn. Additionally, states' year-end general fund balances were substantially lower as a percentage of general expenditures in 1988 than in 1978, as figure 4.5 shows. As the figure also makes clear, in both percentage and absolute dollar terms, fund balances followed a ragged trend in the 1980s, but one that generally declined.

Figure 4.5: State Year-End Fund Balances (1978-88)



Source: State Policy Reports, vol. 5, no. 8, April 26, 1987, p. 5.

Trends of the Past Decade Raise Important Issues for Federal Policymakers

Over the past decade, federal budget and regulatory trends have moved the intergovernmental system in different directions. While budget trends helped to elevate the states to the center of domestic policymaking and leadership, regulatory trends lessened state authority without reducing state responsibility. Both raise important issues for federal policymakers. As a result of the high degree of shared responsibility among federal, state, and local governments in the intergovernmental system, the success of federal domestic programs depends on an effective partnership among these governments. Thus, federal fiscal and regulatory trends that significantly affect states and localities also may have important implications for the federal government. Based on our review of these trends, we identified three emerging issues that have such implications.

- First, the fiscal gap between wealthier and poorer states and localities has widened. Although the federal government depends heavily on the institutional and financial capacity of state and local governments to administer its grants-in-aid programs, over the past decade federal budget cuts helped to widen the fiscal gap between wealthier and poorer states and localities. This, in turn, is one warning sign that inequities in the levels of basic state and local public services (e.g., police, primary education, and infrastructure) may be increasing. It also may indicate that some communities lack sufficient revenues from their own sources to meet their share of federal program costs, thereby undermining national goals and objectives.
- Second, tensions have mounted over the past decade as regulation of states and localities increased. The federal government depends heavily on the goodwill and cooperation of state and local governments to implement its regulatory programs. Thus, it is in the federal interest for these governments to share federal objectives. States and localities should also be in overall agreement with federal program structure and management. Yet state and local officials we interviewed were disturbed by the growth and cumulation of federal mandates and regulatory requirements. Over the same period, federal funding supporting the programs declined, and traditional management techniques used to create cooperation and consultation among levels of government atrophied, adding to these tensions.

We believe that intergovernmental regulation plays a very useful role in the achievement of federal goals and objectives. Yet, we also believe that the cumulative effect of these increases—coupled with decreasing federal aid—ultimately could force state and local governments to choose between meeting their service responsibilities and fulfilling national regulatory objectives. This kind of divergence in state and national priorities is likely to reduce the effectiveness of these governments as agents of national regulatory policies, especially during periods of economic decline. Given the importance of providing basic state and local services and attaining federal regulatory objectives, neither situation would be satisfactory.

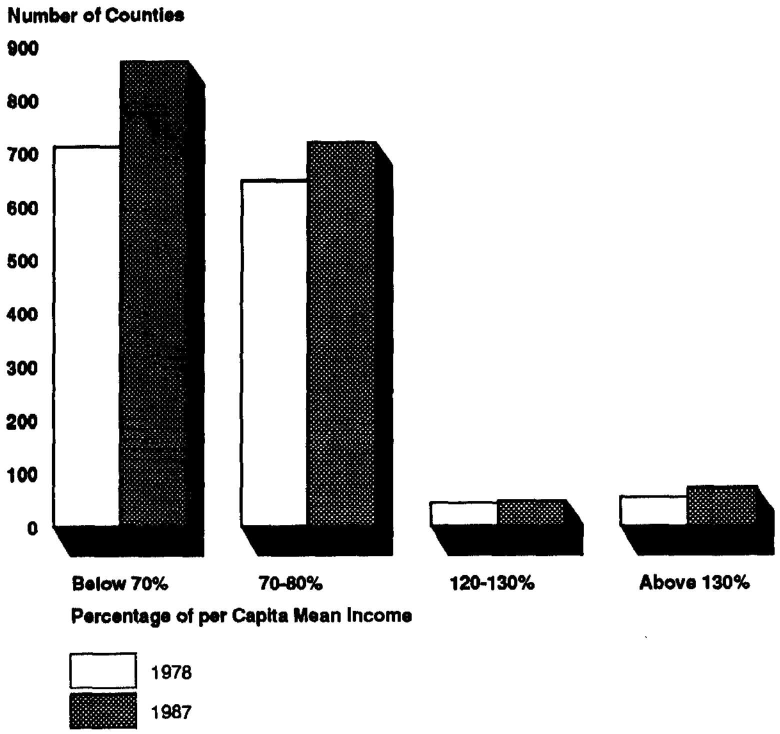
- Third, fiscal and regulatory trends pose concerns for growing state leadership. By the end of the decade we examined, states had reemerged as principal domestic partners with the federal government and had become policy leaders and program innovators in their own right. However, precisely because states occupy an increasingly central place in the intergovernmental system, these trends may eventually place too much fiscal pressure and program responsibility on states, especially during periods when national or regional economies are weak. This, in turn, might slow—or even reverse—the aforementioned progress.

Federal Budget Trends Exacerbated Growth in State and Local Fiscal Disparities

Neither fiscal circumstances nor the need for public services are uniform across states and localities. Both vary, often so that communities with the greatest needs have the least resources to meet them. Fiscal disparities characterize the situation in which different jurisdictions must tax their citizens and businesses at different levels to obtain similar amounts of revenue. These disparities—both among states and across localities—increased during the past decade.

Per capita income is commonly used to measure fiscal disparities because it captures revenue raising capacity and the relative ability to bear tax burdens. Using per capita income to assess fiscal disparities, figures 5.1 and 5.2 show that, after decreasing in the late 1970s, disparities among counties began to grow in the 1980s.

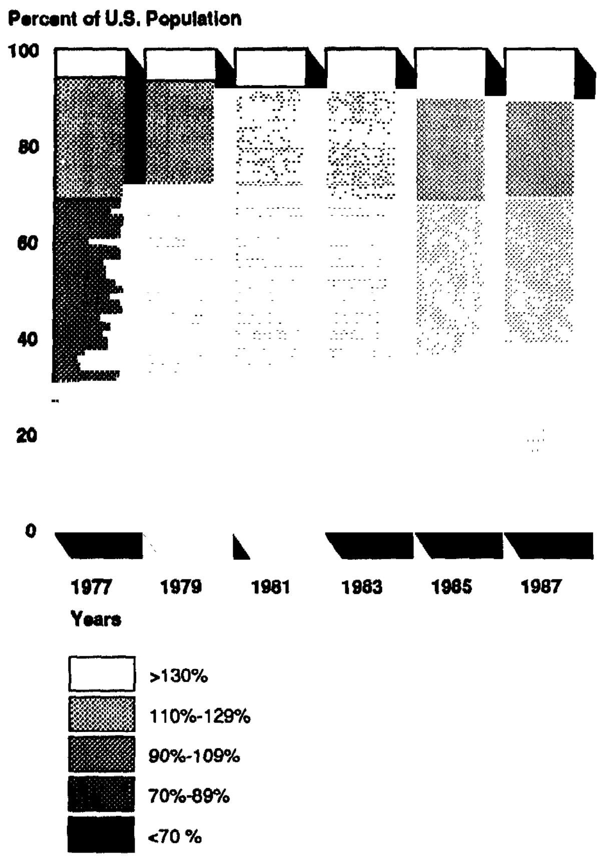
Figure 5.1: Number of Counties Above or Below the National Per Capita Mean Income in 1978 and 1987



Source: GAO calculations based on U.S. Department of Commerce Bureau of Economic Analysis data.

For example, figure 5.2 shows that the number of very poor counties (where per capita income was below 70 percent of the national average) rose from 711 to 871, a 22-percent increase. In contrast, the number of very wealthy counties (where per capita income was above 130 percent of the national average) rose from 54 to 72, a 33-percent increase. Moreover, figure 5.3 shows that over the past decade the U.S. population has become increasingly concentrated in wealthier or poorer counties, with fewer people living in middle-income counties in 1987 than in 1977.

Figure 5.2: Population of Counties, Classified by County Per Capita Personal Income as a Percentage of U.S. Per Capita Income (1977-87)



Percentages in the legend represent percentages of the average per capita personal income for the United States.

Source: GAO calculations based on U.S. Commerce Department Bureau of Economic Analysis data.

The increases in disparities between wealthier and poorer communities are chiefly attributable to changing economic conditions, but reductions in federal grants-in-aid have exacerbated their impact because, by and large, grants have constituted a greater proportion of total revenues of poor communities than of wealthy ones. As a result, federal aid reductions when expressed as losses in shares of total government revenues may be taken as an indicator that disparities are growing.

State and Local Officials and Intergovernmental Experts Believe Regulatory Trends Cause Problems

There was a consensus among the state and local officials and experts we interviewed that recent federal regulatory trends pose a problem to their leadership. In particular, the expectation that regulatory requirements, mandates, and preemptions would accelerate was identified as an important negative trend on the intergovernmental horizon. Not only did experts foresee accelerating financial burdens that would stem from new federal requirements and mandates as problematic from the perspective of state and local fiscal systems, they also see the prospect of nonconsultation in the design of programs as a counterforce to the progress of states as leaders and program innovators.

Yet the trend could continue for the following reasons:

- Regulation of states and localities is a relatively easy strategy for the federal government to use to achieve national objectives without increasing federal fiscal commitments, and
- judicial protection against at least some forms of federal intervention had been presumed to flow from the Tenth Amendment. But this was laid to rest by the Supreme Court as a result of its recent holdings in the Garcia v. San Antonio Metropolitan Transit Authority and South Carolina v. Baker decisions (see app. I).

State and local officials and experts we interviewed told us that the burden associated with all forms of federal regulation affecting state and local governments has increased over the past 10 years. A number of those we interviewed attributed some of the rise in intergovernmental regulation to the fact that it provided federal policymakers an attractive way to achieve national objectives without adding to the deficit. For example, Governor Michael Castle of Delaware has concluded that—through intergovernmental regulation—the Congress can shift the tax burden for its decisions to the states, forcing them to be tax collectors for federally mandated programs.

Those we interviewed also regard insufficient consultation in the design of regulatory programs as a problem. With respect to formal mechanisms, the decline of traditional management techniques that encourage intergovernmental cooperation and consultation has most likely exacerbated the problem. While the Reagan administration regarded these kinds of management tools as unnecessary given its plan for simplifying intergovernmental relations, a streamlined system for such relations was never achieved. As we found, the intergovernmental system was more complex in 1988 than in 1978. Thus, the abandonment of techniques designed to promote consultation and cooperation in the development and implementation of domestic programs seems premature.

Overall, there appears to be a growing paradox in the intergovernmental system stemming from increased intergovernmental regulation. As one intergovernmental expert we interviewed said, there is a perception of a "state renaissance" on one hand, but a lack of "political respect" at the national level for state authority on the other. This expert said that:

> "The states are perhaps more qualified and professional than they have ever been, yet simultaneously are treated worse at the national level."

Out of its concerns about these trends, the National Governors' Association (NGA) has undertaken studies of how to address its "balance of power" concern. While NGA identified a range of possible solutions, many states are seeking a constitutional amendment to better protect their role in the federal system. The association took the first step at its August 1988 meeting by asking the Congress for an amendment that would allow the states to initiate constitutional amendments without calling a convention. This, NGA believes, would make the threat of constitutional change more credible, in turn making the Congress more responsive to state concerns. According to the association, such an amendment would provide a new "check-and-balance" tool in lieu of institutional protection accorded by the Court before the Garcia and South Carolina decisions.

Federal Budget and Regulatory Trends Could Adversely Affect State Prominence

By the end of the decade we examined, states had reemerged as principal partners with the federal government and domestic policy leaders and program innovators in their own right. Because heightened state prominence reduces dependence on the federal government and enhances opportunities for domestic policy innovation and problem solving, it was viewed by those we interviewed as a positive development that should be encouraged. Moreover, in light of federal budgetary pressures, it is in the federal government's interest for states to play an increasingly active role with respect to achieving national program objectives. Clearly, if states are to progress further, however, maintaining this momentum is important.

While progress can never be fully assured, the combination of federal budgetary and regulatory trends described in this report appears to pose a special concern to the rise of states as leaders and innovators for the following reasons. First, the overall decline of federal aid and the reduction of grants-in-aid from the federal to local governments in particular have put pressure on states to make up lost revenues, both in their own programs and in those administered by localities within their jurisdiction. We expect these pressures to continue, or even accelerate, as the federal government pressures the states to help implement new federal programs to address domestic problems.

Second, with respect to the proliferation of regulations, state and local officials and experts we interviewed rejected the adage, "You can't get too much of a good thing." Instead, they cautioned that federal reliance on unfunded regulation should be used judiciously in the future. It is important for federal policymakers to consider the costs of such regulations and how regulations promulgated at different points in time and in different policy areas interact. Inadvertently, mixtures of conflicting and overlapping regulations may reduce the flexibility of states to deliver public services and administer federal programs.

Finally, economic circumstances are not uniform across states and localities. Different conditions exist, making some states and regions more vulnerable to this conflicting combination of federal budget and regulatory trends. And all states—by virtue of their vulnerability in times of recession—face the prospect that an economic downturn may exacerbate the problem of meeting state-determined public service needs and priorities while also responding positively to national grant and regulatory program goals and objectives. This, in turn, might slow—or even reverse—state progress, progress that over the past decade has reduced the dependence of states on the federal government, increased state support for local governments, and helped the federal government to achieve its myriad domestic goals and objectives.

Key Intergovernmental Events: 1978-88

During the 1978-88 period, two sets of events pulled the intergovernmental system in opposite directions and contributed to important changes in its character. The first set is comprised of measures that decentralized the federal system by narrowing the federal role and broadening that of the states. At the outset, two events—the tax revolt of the late 1970s and the election of Ronald Reagan as president in 1980—signified the arrival of a more conservative era in national politics and set in motion the process of federal retrenchment. Thereafter, the passage of the Omnibus Budget Reconciliation Act of 1981, the Economic Recovery Tax Act of 1981, the Gramm-Rudman-Hollings Act of 1985, and the Tax Reform Act of 1986 shifted greater responsibility for financing and delivering public services to state and local governments.

During this same period, other factors pulled intergovernmental relations in the opposite direction and broadened federal authority over state and local affairs. In areas of new or heightened public concern, demands for national leadership sometimes led the federal government to increase its role in domestic policy. In particular, new or lesser-used tools of federal action were exploited in lieu of more traditional grants-in-aid, notably preemption, regulation, and direct mandating of state and/or local action. Moreover, two recent Supreme Court rulings determined that the Congress and national political processes, not the judiciary, should decide the balance of power between federal and state governments.

Proposition 13

To begin chronologically, California's Proposition 13, passed in 1978, limited property tax rates, thereby slowing the rate of growth of public spending in that state. The passage of this citizen-based initiative was significant for the intergovernmental system because it indicated public support for more limited government.

Election of President Reagan

The inauguration of President Ronald Reagan signaled the arrival at the national level of a chief executive committed to reducing the size and scope of government and to an intergovernmental system giving much greater prominence to states and localities. In particular, his objectives were:

- to shrink the role of all levels of government in comparison with the private sector. To achieve this objective, the administration made strong efforts to cut taxes, eliminate grant programs, deregulate areas of social regulation, and privatize governmental functions.

- to return to a more "dual" form of federalism by stepping back from the "cooperative" federalism that had evolved over the past 50 years. This effort manifested itself in the elimination of federal intergovernmental communication structures, revisions of federal guidance on regulations and rules for managing federal aid, and the creation of block grants as a substitute for categorical programs.
- to devolve certain federal responsibilities to the subnational level. This included successful efforts to end federal involvement in many regional cooperation programs within and among states, to establish primacy for states in social regulatory programs, and to reduce substantially federal enforcement in these same programs. It also included the ill-fated 1982 welfare swap proposal,[1] which would have removed the federal government from several significant income security programs.

Altogether, the Reagan administration employed four specific strategies to achieve these objectives: budget cuts, tax cuts, block grants, and regulatory relief initiatives. And the President experienced moderate success in these efforts. As a result, Reagan federalism strategies are evident in other events of the decade identified as important in this report. They are (1) the Omnibus Budget Reconciliation Act of 1981 (OBRA); (2) the Economic Recovery Tax Act of 1981 (ERTA); (3) the so-called Gramm-Rudman-Hollings Act of 1985 (GRH); (4) the elimination of the General Revenue Sharing program in 1986 (GRS); (5) the Tax Reform Act of 1986 (TRA); and (6) two Supreme Court decisions, Garcia v. San Antonio Metropolitan Transit Authority (1986) and South Carolina v. Baker (1988).

Omnibus Budget Reconciliation Act (1981)

In fiscal year 1981, there were some 538 separate federal grant programs, prompting great concern among policymakers about how best to manage and control the system. One way, which gained support in the early 1980s, was to reduce the grant system's size and complexity. Thus, in 1981, legislation including the Omnibus Budget and Reconciliation Act cut domestic spending by $35 billion, eliminating 59 grant programs and consolidating nearly 80 narrowly focused categorical grant programs into nine broad-based block grants. Significantly, many of grants eliminated by OBRA had been federal-local, while all the block grants created by it were state-administered. The objectives of these efforts were (1) to

[1] Under this proposal the federal government would have returned to the states full responsibility for funding the Aid to 'Families with Dependent Children and Food Stamp programs in exchange for the federal assumption of state contributions to Medicaid. See Timothy Conlan, New Federalism: Intergovernmental Reform From Nixon to Reagan. (Washington, D.C.: The Brookings Institution, 1988), p. 185.

focus greater program responsibility at the state level; (2) improve service delivery by fostering better integration of related federal and state programs; and (3) save 25 percent over the cost of the folded-in programs by emphasizing the use of existing state administrative systems. In retrospect, OBRA reduced the size and complexity of the intergovernmental grant system only marginally. Yet the passage of this act was significant because it visibly enhanced the position of states in the federal system at the expense of localities, while also reducing federal financial commitments in the programs eliminated or turned into block grants by OBRA.

Economic Recovery and Tax Act (1981)

The Economic Recovery and Tax Act (ERTA) of 1981 reduced federal income tax collections from corporations and slowed the rate of growth for individual income tax receipts. Without countervailing budget cuts, however, the federal deficit began to grow dramatically in the aftermath of this historic legislation. Tax losses associated with ERTA were estimated to have been $294 billion by 1987, and this led directly to passage of the Tax Equity and Fiscal Responsibility Act (TEFRA) in 1982. In retrospect, the passage of ERTA was a significant event in intergovernmental relations because it reduced federal revenue-raising potential, which, in turn, launched the present quest for cuts in all forms of discretionary spending, including intergovernmental grants, loans, and tax subsidies.

Gramm-Rudman-Hollings Act (1985)

The Balanced Budget and Emergency Deficit Control Act of 1985, better known as Gramm-Rudman-Hollings or GRH, established deficit-reduction targets for the federal government that were intended to force policymakers to balance the budget by 1992. Under GRH, if established targets are not met, sequestration and subsequent across-the-board cuts occur automatically. While there has been only one sequestration and GRH has been weakened by amendment and statutory interpretation, the law is an important event in intergovernmental relations. GRH gains its significance because, since its passage in 1985, legislators must, in effect, find comparable budget savings to offset the federal costs of new programs.

Garcia v. San Antonio Metropolitan Transit Authority (1985)

In Garcia the Supreme Court ruled that state and local employees are covered by the federal Fair Labor Standards Act (FLSA). In so doing, the Court affirmed that Congress has broad power to regulate the wage and hour laws of state and local employees. Of more general importance, the Court overturned an existing precedent established in National League of Cities v. Usery (1976) that—at least in areas of integral state and local operations—the Constitution prohibits direct federal regulation of these governments. Perhaps most significantly, the Court officially renounced its historical role of judicial umpire between the federal and state governments with respect to claims of protection under the Tenth Amendment, reserving for the states, or to the people, those powers not delegated to the national government or constitutionally denied to the states. Thus, Garcia is important for the intergovernmental system because it firmly established the judicial principle that state and local government participation in national political processes is the most acceptable means of redress against unwelcome federal intervention.

The Tax Reform Act of 1986

As part of a successful effort to lower individual and corporate tax rates by broadening the tax base, the Tax Reform Act of 1986 eliminated the deduction for state sales taxes previously enjoyed by individuals who itemize on their federal tax returns (TRA-86 left identical preferences for income and property taxes untouched). The decision to eliminate the sales tax deduction was controversial in a number of respects. Because burdens fell disproportionately on states that rely heavily on sales taxes for revenue, selective elimination was criticized as discriminatory. Moreover, because it constituted an incentive to alter the structure of state and local taxation, selective elimination was viewed as an undue interference in state and local finance decisions. Finally, some state and local officials feared that eliminating the sales tax deduction was only the first step in a process that ultimately would end such deductions altogether.

TRA-86 also placed stricter limits on the use of tax-exempt bonds, especially private-activity revenue bonds. Not only did TRA-86 lower existing limits on bond volume dramatically, to $50 dollars per capita issued per year in most states, it also placed more categories of bonds in this capped category. Finally, TRA-86 contained a substantial number of new provisions designed to curb perceived abuses in public-private partnerships and in cash-management strategies regarded by the Congress and the Treasury Department as schemes explicitly intended to generate arbitrage.[2] TRA-86 changes are important for the intergovernmental system for several reasons. Altogether, they raise the level of federal intrusiveness in state and local finance significantly. In particular, the restrictions of TRA-86 on the deductibility of state and local taxes are the

[2]Arbitrage is earned when states and localities invest bond proceeds in higher-yielding securities before expending funds. For example, before passage of TRA-86 states and localities commonly invested bond proceeds in higher-yielding securities during often lengthy capital project construction periods.

first since passage of the modern income tax in 1913. Moreover, TRA-86's bond reforms have restricted a primary source of capital at a time when state and local governments are relied on more heavily to finance infrastructure and other capital projects.

Elimination of General Revenue Sharing (1986)

At one time, the general revenue sharing (GRS) program (enacted in 1972) distributed virtually unconditional fiscal assistance to all 50 states and about 39,000 general purpose local governments. The program was eliminated for states in 1980 and for local governments in 1986. From an intergovernmental relations perspective, the termination of revenue sharing is significant for reasons related to its philosophy and funding. While the program was sometimes criticized for giving state and local governments too much discretion and federal budget deficits probably made it politically untenable, GRS had a number of commendable features. First, the program made maximum use of subnational administrative structures, making it among the most economical of intergovernmental aid programs to administer. Second, GRS had very few conditions attached to it, making it among the most flexible grants-in-aid. Finally, revenue sharing was moderately targeted at the local level. GRS was one of only 29 programs that used income as part of their allocation formulas.

The elimination of the local-government component of GRS in 1986 is especially significant for intergovernmental relations because it further reduced (and in the case of many very small towns and townships it eliminated) federal-local grants. It is also an important event because in some communities revenue sharing constituted a significant share of total revenues—as much as 23 percent in some fiscally distressed places. The loss of GRS forced many such governments to seek replacement revenues or to reduce services.

South Carolina v. Baker, Secretary of the Treasury (1988)

In South Carolina, the Supreme Court affirmed its Garcia reasoning that states must seek protection from unwelcome federal regulation through national political processes. As the majority opinion restated, the Court will not restrict the federal government's reach by searching out doctrinal limits on it in the Tenth Amendment. In particular, the Court ruled invalid South Carolina's claims that conditioning federal tax exemption on a TEFRA requirement that state and local bonds be issued in "registered" rather than "bearer" form violated the Tenth Amendment and the principle of reciprocal tax immunity. And, having dismissed both charges, the Court negated a nearly 100-year old Supreme Court precedent (Pollock v. Farmer's Trust), which heretofore had been deemed to protect municipal bond interest from federal taxation.

South Carolina is important for the intergovernmental system because it reinforced the Court's position that political and administrative, rather than judicial, actions are to define the relationship between the national and state governments. With respect to intergovernmental finance issues, the decision is a watershed event because it explicitly establishes the superiority of the federal government in matters of tax immunity. Moreover, by making municipal bond law a matter of statutory preference rather than constitutional principle, the Court opened the door to further federal regulation of state and local finance decisions. After South Carolina it is clear that the Congress has the right not only to regulate abuse and control the volume of municipal bonds, but that it also has the power to render bonds issued for any purpose—including basic public infrastructure—taxable.

Persons Interviewed to Develop Issues in This Report

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Wayne F. Anderson	Professor, George Mason University
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Frank Sturzel	Executive Director, Texas Municipal League
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Gordon Arnold	Executive Assistant to the Speaker of the House of Representatives, State of Texas
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Robert Bradley	Executive Director, Advisory Council on Intergovernmental Relations, State of Florida
Martin Young	Policy Coordinator, Office of Planning and Budgeting, State of Florida
Raymond Sittig	Executive Director, Florida League of Cities
Hon. Larry Durence	President of Florida Lake City, City of Lakeland, Florida
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Ann Alter	Intergovernmental Specialist, Office of the City Manager, City of Colorado Springs, Colorado
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Bibliography

Block Grants: Federal-State Cooperation in Developing National Data Collection Strategies (GAO/HRD-89-2, Nov. 29, 1988) Washington, D.C.

GAO believes the cooperative approach to data collection is a viable way to obtain national block grant data although some data may not be comparable. Generally, the data gathered were timely and officials in the six states we reviewed perceived the data collection efforts to be less burdensome than reporting under the prior categorical programs. But the voluntary approach may not be useful for other federal programs due to the incomparability of the data collected.

Legislative Mandates: State Experiences Offer Insights for Federal Action (GAO/HRD-88-75, Sept. 27, 1988) Washington, D.C.

GAO found that federal mandate cost estimating had little effect on five of the eight bills reviewed because legislators were more concerned with program and policy issues than with the costs they imposed on states and localities. But cost estimates had a significant impact in the states when prepared early in the legislative process. Mandate reimbursement worked in the states if the public initiated the requirement through a referendum or there existed a constitutional amendment requiring it, and the state was experiencing a healthy fiscal climate. GAO believes that the federal government could focus attention on the impact of federal legislation on state and local costs by providing estimates for key bills before full committee reports and biennial reports to increase legislators' awareness of mandated costs.

Block Grants: Federal Set-Asides for Substance Abuse and Mental Health Services (GAO/HRD-88-17, Oct. 14, 1987) Washington, D.C.

We studied eight states and found that: (1) most states allocated their funds according to historical trends to maintain existing services, (2) states met the requirement to set aside funds either by expanding existing services or by passing on the responsibility to local or county service providers, (3) most states neither received increased block grant funds nor provided additional funding to service providers, (4) most state officials stated that they would continue these services even without the set-aside requirement, and (5) a majority of recipient interest groups believe that their states' commitments to the services would decrease if the Congress eliminated the set-aside.

Grant Formulas: A Catalog of Federal Aid to States and Localities (GAO/HRD-87-28, Mar. 23, 1987) Washington, D.C.

The catalog provides: (1) an in-depth understanding of formula allocation, (2) information on the agencies and congressional committees that have jurisdiction over the programs, (3) the amounts of program allocations, and (4) the sources and timeliness of the statistical data used in making funding allocations.

Health Care: States Assume Leadership Role in Providing Emergency Medical Services (GAO/HRD-86-132, Sept. 30, 1986) Washington, D.C.

States have assumed a more active leadership role in financing and regulating the local delivery of emergency medical services. The six states GAO visited reversed the trend of reducing funds for emergency medical services and the emergency medical services community increasingly looked to the states—and not the federal government—for leadership.

Local Governments: Targeting General Fiscal Assistance Reduces Fiscal Disparities (GAO/HRD-86-113, Jul. 24, 1986) Washington, D.C.

Retargeting general fiscal assistance would produce double the reduction in disparities if only those communities with incomes below 125 percent of their states' average income received assistance. Poorer communities must accept lower levels of public services or tax themselves more heavily to achieve equalization of services under the present program. GRS allocated funds to local governments within each state based on population, per capita income, and tax effort.

Child Support: States' Implementation of the 1984 Child Support Enforcement Amendments (GAO/HRD-86-40BR, Dec. 24, 1985) Washington, D.C.

The Child Support Enforcement Program is a federally administered, state-run program established to require absent parents to support their children and, as a result, to reduce Aid to Families with Dependent Children (AFDC) program funding. In 1984, the Congress enacted amendments mandating states to adopt and implement 10 practices to improve the program's ability to: (1) mandate proven collection techniques (2) ensure that services will be available to non-AFDC families, and (3) strengthen interstate child support enforcement.

Block Grants: Overview of Experiences to Date and Emerging Issues (GAO/HRD-85-46, Apr. 3, 1985) Washington, D.C.

Block grant implementation proceeded relatively smoothly during the first 2 years because the states have prior administrative involvement in many of the programs included under the blocks. Continued availability of categorical grant funds, supplemental federal assistance, and discretion to transfer between the blocks, helped to offset reduced federal spending under the block grants. The states tended to seek program continuity under the blocks. The states favored the block grant approach while interest groups favored the prior categorical approach.

State Rather Than Federal Policies Provided the Framework for Managing Block Grants (GAO/HRD-85-36, Mar. 15, 1985) Washington, D.C.

GAO found that block grants provided the states with greater discretion to plan and manage federal funds using existing state procedures. The states indicated that the broader discretion enabled them to better integrate related state and federal activities. As states gained experience, the need for additional federal technical assistance diminished.

States Have Made Few Changes in Implementing the Alcohol, Drug Abuse, and Mental Health Services Block Grant (GAO/HRD-84-52, Jun. 6, 1984) Washington, D.C.

GAO found that increased state funding and reallocated categorical grants were used by states to offset reduced federal appropriations for Alcohol, Drub Abuse, and Mental Health services. No states changed client eligibility policies, among those states we reviewed, and most continued to fund the existing service provider network. States carried out their increased responsibilities by establishing program requirements, monitoring grantees, providing technical assistance, and auditing funds.

Summary of Recent GAO Reports on Managing Intergovernmental Assistance Programs (GAO/GGD-82-91, Jul. 13, 1982) Washington, D.C.

A major conclusion of GAO reports over the years has been that, since the federal government relies so heavily on state and local governments to implement national objectives on a partnership basis, the federal level needs to design programs that are more sensitive to the fiscal, legal, and administrative environments of state and local governments.

Removing Tiering from the Revenue Sharing Formula Would Eliminate Payment Inequities to Local Governments (GAO/GGD-82-46, Apr. 15, 1982) Washington, D.C.

GAO found that revenue-sharing allocations to city and township governments results from three sources: (1) the three formula elements of population, relative income, and tax effort applicable to each unit of local government, (2) statutory formula constraints, and (3) the statutory tiering process. The effect is to distribute more aid to governments with more people having lower incomes and supporting a higher tax effort. But the tiering process also causes inequities by penalizing those governmental types with a higher concentration of low-income residents in states characterized by rural poverty. Eliminating tiering and directly applying the basic three-element formula to local governments would reduce inequities.

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