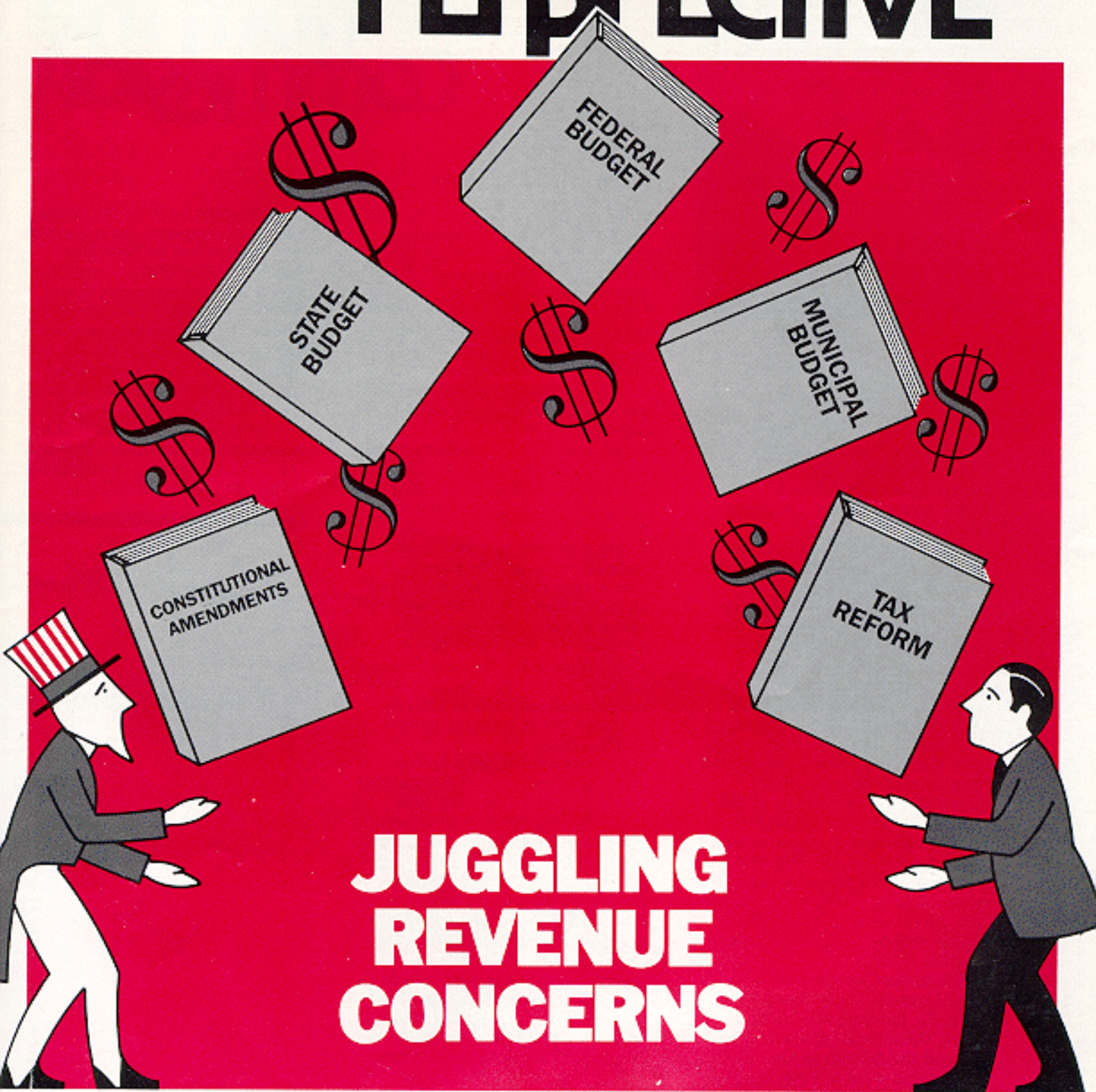


Intergovernmental **PERSPECTIVE**



JUGGLING REVENUE CONCERNS



View From The Commission

Dear Reader:

Until fairly recently, most intergovernmental attention was focused on federal grants. Now, the federalism debate is shifting to the revenue side of the equation.

Changes in federal tax policy foreshadowed this shift. The *Economic Recovery Tax Act of 1981* may be viewed as the beginning of a new chapter in federal-state-local relations. The most significant change in intergovernmental terms in the 1981 legislation was the Accelerated Cost Recovery System depreciation method. Because many states used the federal code to determine depreciation, the new ACRS meant the loss of millions of dollars from state treasuries. Not surprisingly, many states decoupled from the federal depreciation system to avoid this loss and, more fundamentally, state leaders had good reason to look at the merits of close conformity to federal tax rules.

The federal government also raised certain excise taxes. In 1982, for the first time in 20 years, the federal cigarette excise tax and the federal excise tax rate on gasoline were at least doubled. With the long federal status quo,

many states had come to view excise taxes as "their" revenue sources and would increase these taxes to make up for small shortfalls in their budgets. It should be noted that this federal action did not result in states avoiding these taxes. In fact, several states, including my own, have raised their tobacco or gasoline taxes, or both, since Congress imposed these higher rates in 1982.

Other legislation under current consideration would raise the excise tax on alcoholic beverages and would make part of the temporary cigarette tax increase permanent. Another threat to state-local use of selective taxes comes from the Advisory Council on Social Security which wants to earmark revenues from excise taxes to cover the anticipated Medicare deficit. The debate over curbing industrial revenue bonds is the latest example of the importance of tax policy to states and localities.

At the Commission's Spring meeting, these and other proposed federal tax changes were measured for their intergovernmental effects. ACIR came out strongly in favor of protecting the basic tenets of fiscal federalism and the abilities of states and localities to raise revenues to finance the levels of services they find desirable.

This issue of **Intergovernmental Perspective** deals with tax interrelationships. The first article discusses the potential impact on states and localities of proposed changes in federal tax policy. The second highlights what local governments are doing

to make ends meet in the 1980s. The third compares our system of fiscal federalism to West Germany's. Unlike West Germany where the national government raises and redistributes revenues, several levels of taxing authority compete for resources within the framework of American federalism. The challenge of the remainder of this decade may well be reconciling the many conflicting interests that can arise when federal, state, and local governments vie for the same tax dollars.

David E. Nething
Majority Leader
North Dakota State Senate

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Intergovernmental FOCUS

Regional Councils Changing, Survey Finds

Results of a 1983 survey of substate regional councils have recently been made available by the National Association of Regional Councils (Special Report No. 91, January 1984, NARC, 1700 K Street, N.W., Washington, DC 20006). The two principal findings are that (1) regional council activities and funding sources have diversified greatly, and (2) federal funding has receded substantially—from 76% of the typical council budget in 1977 (as reported by the Census of Governments) to 48% in 1983. Another significant fact that emerged is that over half (56%) of these regional organizations have some in-house computer capability—a completely new development for many.

Over the past decade, land-use planning and environmental protection concerns have remained on the agendas of most regional organizations. During the same period, activities in the fields of economic development, transportation, housing, human services, management and assistance, and computer services have become much more frequently included on these agendas. Each of the activities mentioned above was reported in the work programs of well over half of the 335 substate regional councils responding to NARC's 1983 survey.

Revenue diversification by regional councils has taken several forms. States, local government, and "other" sources of funding all support larger proportions of regional budgets, now that federal funds have been cut back. State funding in 1983 accounted for 17 percent of regional council budgets, compared to 10 percent in 1977, while the local share of these budgets rose from 12 to 19 percent. In both cases, contract services became a much more prominent part of this funding, in comparison to grants for general support of the regional organizations. Funds from other sources have risen from 2 to 16 percent. They are provided by "other" service contracts (6%), regional taxes (3%), foundation grants (1%), and miscellaneous sources (6%).

The new roles of service contracts may be the most significant feature of this fiscal realignment. Combining the state, local government, and other service contracts, 23 percent of regional council budgets now come from such contracts—a figure roughly equivalent to the 28 percent reduction in the federally-supplied portion of the budget. Most regional council budgets are not only substantially smaller, but the flexibility to spend in accordance with the council's own regional priorities has also been reduced. In fact, the new service contracts often provide a council with less flexibility than the federal grants they replaced, and they are less supportive of broadly-conceived planning activities.

Intergovernmental Regulatory Relief Act Introduced

On March 8, 1984, Senator David Durenberger (MN), Chairman of the Senate Intergovernmental Relations Subcommittee, introduced the Intergovernmental Regulatory Relief Act of 1984. The bill will relieve state and local governments from costs they may incur when complying with federal regulations:

- by reimbursing state and local governments for direct costs they incur in complying with new regulations;
- by requiring a reduction in existing costs either by reimbursement, by reducing the regulatory requirements themselves, or by a combination of the two.

If such relief is not provided for, the bill prohibits any federal agency or court from enforcing the unreimbursed regulation.

The bill also requires the President to prepare an annual report estimating total costs incurred by state and local governments in complying with federal regulations.

Senator Durenberger said that the basic premise behind the bill is that if Congress passes legislation to pursue a national purpose, the federal government, not the states or cities, should pay the costs of achieving it:

It's time to put an end to our unsavory practice of shifting cost onto

state and local governments. If we want the credit for solving social problems, we (Congress) must state our objectives clearly and vote openly to spend scarce Federal dollars to pay for the solution.

In its recently published study on regulatory federalism, the Advisory Commission on Intergovernmental Relations (ACIR) has identified more than 35 major federal regulatory statutes employing intergovernmental regulations that place significant fiscal burdens on state and local governments.

Over the years, Congress has passed legislation to achieve a whole range of social and economic goals. In implementing these programs, a significant share of the cost has been shifted onto state and local governments. This cost shifting occurs through various forms of federal rules and regulations and their interpretation by the courts. For example:

- **Direct orders**, which mandate state and local actions under threat of civil or criminal penalties, such as the Equal Employment Opportunity Act of 1972;
- **Crosscutting**, or generally applicable requirements imposed on many or all assistance programs grants to further a wide range of social and economic policies. These requirements, including bans on discrimination on the grounds of race, sex and handicapped; environment impact statement procedures; and Davis-Bacon Act prevailing wage rules, must be adhered to by recipients of federal assistance or the aid can be suspended. In a recent OMB inventory, 36 across-the-board requirements dealing with various socioeconomic issues, as well as 23 administrative and fiscal policy requirements, were identified;
- **Crossover sanctions**, in which the failure to comply with the requirements of one program may result in the reduction or elimination of aid funds provided under other specified programs, as exemplified by the requirement that states having speed limits in excess of 55 MPH not receive fed-

eral funds for highway construction or under the National Health Planning Act; and,

- **Partial preemptions**, which establish a national federal standard, but authorize states to implement the program if they adopt standards at least as stringent as the federal ones, as provided by the environmental protection and OSHA laws. In either instance, states bear much of the cost of implementing the federal or greater standard.

Senator Durenberger stated that the Intergovernmental Regulatory Relief Act of 1984 is based on the findings and recommendations of the ACIR.

Furthermore, Senator Durenberger stated his intention to introduce two additional bills aimed at federalism reform. One will address the technical questions of writing and managing federal regulations directed at state and local governments. The other will go to more fundamental questions of state-federal relations in the areas of federal preemption of state laws and direct federal orders that come in the form of both legislation and court decisions.

The Subcommittee plans to hold hearing this spring on the Intergovernmental Regulatory Relief Act of 1984.

The Supreme Court So Far . . .

Although a few cases of extreme intergovernmental significance remain to be decided—thus preventing a final assessment of the 1983-84 Supreme Court Term—once again, as in previous years, the Burger Court has exhibited no clear voting blocs nor any consistent view of judicial federalism. Hence, the states prevailed in important grant law, Eleventh Amendment, and antitrust cases, but came out badly on the losing side of the judicial ledger in the always tension-filled realm of preemption.

At issue in the major grant law case of the Term, *Norfolk Redevelop-*

ment and Housing Authority v. Chesapeake and Potomac Telephone Co. of Virginia, was the Uniform Relocation Assistance and Real Property Acquisitions Act of 1970. The Act applies to most displacements caused by government programs using federal funds other than General Revenue Sharing. The case in question arose when Chesapeake and Potomac Telephone requested relocation assistance after it was required to move some of its transmission facilities from a public right-of-way as part of a Norfolk urban renewal project. Although businesses as well as people may be considered "displaced persons" for the purposes of the Act, public utilities are a unique category of business, presenting government with special problems. For example, a long-established principle of common law holds "that a utility forced to relocate from a public right-of-way must do so at its own expense." Thus, *amici* joining the Norfolk Authority asked the Court to decide that "[a]bsent a clear congressional statement that public utilities should be compensated under the statute, the courts should be reluctant to interpret the law in such a way as to obviate decades of State common law . . ." The Court agreed and state and local governments chalked up their first major victory of the Term.

The states achieved another important win when, early in 1984, a narrowly divided Court greatly expanded the Eleventh Amendment, the constitutional provision which gives states immunity from being sued in federal court without their consent. In the now familiar case of *Pennhurst State School and Hospital v. Halderman* (the case yielded an important grant law decision in 1981—See **Intergovernmental Perspective**, Fall 1981) a 5-4 majority ruled that federal judges cannot order "state officials to conform their conduct to state law." The decision is perhaps the most far-reaching to date in a series of Burger Court actions designed to curb the power of the federal judiciary—most notably, in the realm of habeas corpus petitions. The newest *Pennhurst* decision may prevent federal judges from questioning

state officials on their policies concerning state institutions, such as prisons and mental facilities, governed by state laws.

State interests were also victorious this Term in the still evolving and as yet legally murky area of official liability under the federal antitrust laws. In *Hoover v. Ronwin*, the Court held that state bar officials cannot be sued under the antitrust laws by people denied admission to a state's bar. Arguing that Arizona bar officials, by allowing only a set number to pass the bar exam rather than all those surpassing a set standard, Ronwin sued the bar and its officials charging a restriction of competition. By a 4-3 plurality, the Court ruled that bar examiners are an arm of the state supreme court and thus are covered by the state's broad immunity from the antitrust laws. Lacking a majority, the precedential value of the decision may be limited. However, it should serve as an important guidepost in the continued development of the Court's thinking in this area.

The states found themselves in a less auspicious legal milieu when questions of federal preemption were at issue. Thus, in *Secretary of Interior v. California*—a case pitting Reagan Administration interests against those of the states—a badly divided Court ruled that states may not obstruct federal offshore lease sales on the basis that such transactions are inconsistent with state coastal protection plans.

States suffered another preemption setback when the Court, in a one-sentence order, affirmed an appeals court ruling on a Connecticut ban of double trailer trucks. At issue was a provision of the federal Surface Transportation Assistance Act (STAA) disallowing states from prohibiting such vehicles. Connecticut argued that the law violated its rights under the equal protection component of the Fifth Amendment's Due Process Clause and the Tenth Amendment. The High Court, however, chose to give its blessing to the lower court's assertion that: "In general, the power of Congress to preempt state legislation affecting interstate commerce is sweeping. [I]t is

likely that the Connecticut statute, even in the absence of any congressional preemption, might have an unconstitutional impact on interstate commerce.”

Far less controversial—though a loss nonetheless for one state—was the Court’s unanimous decision in *Aloha Airlines v. Director of Taxation of Hawaii*. In that case, the Court ruled that Hawaii’s tax on the annual gross income of airlines operating within that state is preempted by the Airport Development Acceleration Act of 1973. Section 1513(a) of that Act expressly prohibits states from taxing “directly or indirectly” gross receipts derived from air transportation.

Despite the foregoing losses, the states were judicially blest in one preemption holding. In *Silkwood v. Kerr-McGee* the Court was asked to decide whether federal law preempts state laws under which employees can obtain punitive damage awards from their employers if the companies allow their employees to become radioactively contaminated. Fifteen states joined the *Silkwood* estate; the Reagan Administration supported the position of *Kerr-McGee*. In contrast to the California case, Administration policy was rebuffed and the state position vindicated when a narrowly divided Court found “ample evidence” for ruling that state negligence law may permit awarding punitive damages.

Finally, of interest to city governments attempting to deal with urban and minority unemployment by using set-asides, was the Court’s ruling in *United Building and Construction Trade Council v. Mayor and Council of the City of Camden*. At issue was a Camden ordinance requiring that at least 40% of the employees of contractors and subcontractors working on city construction projects be residents of Camden. The Building and Trade Council sought to have the law declared unconstitutional as a violation of the Privileges and Immunities Clause. That constitutional provision seeks to ensure that citizens from one state who visit a second state are treated in the same manner as the citizens of the second state.

The city argued that municipal ordinances, unlike state laws, are not subject to the strictures of the Clause. Although the Court did not declare the ordinance unconstitutional, it did reject Camden’s contention, remanding the case to the New Jersey Supreme Court for determination of constitutionality. The result may thus be viewed as a mixed blessing; the city has been left open to constitutional attack, but the state has been given final legal say.

1984 State Tax Changes

This year, states with tax changes can be divided into two categories: those states that are still dealing with recession-induced problems (particularly the western and southern energy-producing states), and those states that are experiencing the windfall from a healthy economic recovery (primarily the Great Lakes manufacturing-based states).

The states that still are coping with revenue shortfalls have been raising taxes. So far, three states have increased sales tax rates. These include Louisiana from 3% to 4%; Oklahoma from 2% to 3%; and Tennessee from 4.5% to 5.5%. Three other western states extended last year’s sales tax increases that were slated for expiration this July. Utah maintained the 4.625% rate for three more years, while Idaho permanently adopted a 4% sales tax rate rather than allow the current 4.5% tax to decrease to 3% as was scheduled; and Arizona maintained the 5% rate rather than allow the rate to revert to 4%.

Other significant tax increases include:

- **Arizona** raised the cigarette tax rate from 13¢ to 15¢ per pack and hiked excise taxes for spirits, wine, and beer;
- **Louisiana** increased the cigarette tax rate from 11¢ to 16¢ per pack, changed the motor fuel tax from 8¢ to 16¢ per gallon, instituted a new 5% tax for on-premise consumption of alcoholic beverages, and raised insurance premium, severance, and hazardous waste taxes. A constitutional amendment will be re-

ferred to the voters to increase the corporate income tax base. This tax package, including the proposed amendment, totaled over \$700 million.

- **Oklahoma** raised the gasoline tax from 6.6¢ to 9¢ per gallon, hiked alcohol excise taxes by 25%, and repealed the sales tax exemption for beer and cigarettes;
- **South Dakota** will maintain the 13¢ per gallon motor fuel tax which was enacted as a temporary measure in 1981;
- **Tennessee** increased the corporate franchise tax and insurance premium tax;
- **Utah** raised the franchise and net income tax and severance tax on oil, gas, and hydrocarbons, and hiked the motor fuels tax from 11¢ per gallon to 14¢ per gallon;
- **Washington** instituted a \$30 per month commuter tax targeted at Oregon residents;
- **Vermont** temporarily increased the personal income tax from 26% to 26.5% of federal tax liability and placed a 20% surcharge on corporate income;
- **Connecticut** raised the motor fuel tax from 14¢ per gallon to 15¢ per gallon and provided for an annual one cent increase for each year until 1991 when it will reach 23¢ per gallon;
- **Alabama** increased the motor fuels tax 2¢ per gallon and the cigarette tax from 16¢ a pack to 16.5¢ a pack; and
- **West Virginia** taxpayers will vote on a November legislative referendum to amend the constitution and raise the sales tax from 5% to 6%.
Major tax increases are now pending in the Alabama, Connecticut, Mississippi, and South Carolina legislatures.
Conversely, tax talk in the Great Lakes area centers around tax de-

creases. At this time, Wisconsin has taken action to lift the 10% surtax on personal and corporate income taxes, and Minnesota decided to remove its 10% surtax—both retroactive to January 1984. A personal income tax decrease is imminent in Michigan. Reductions in income taxes also appear likely in Delaware and Pennsylvania.

Other tax decreases include:

- **Georgia** exempted prescription drugs from the sales tax beginning in fiscal year 1986, becoming the 44th state to do so (5 states do not have sales taxes);
- **Nebraska** reduced the personal income tax from 20% to 19% of federal tax liability, automatically triggering a reduction in the corporate income tax because the corporate rate is computed as a set percentage of the individual rate;
- **South Dakota and Washington** lowered severance taxes;
- **Tennessee** will phase-out the sales tax on food purchases over three years beginning in 1985;
- **Colorado** will allow the 3.5% sales tax rate to decrease to 3% as scheduled;
- **Hawaii** will provide a \$1 credit for each exemption on the personal income tax as mandated by the constitutional budget surplus provision; and
- **Rhode Island** decreased the personal income tax from 26% of federal tax liability to 24.9%.

House, Senate Consider Municipal Antitrust Liability

When the Congress adopted the Sherman Antitrust Act of 1890 it intended to circumscribe potentially anticompetitive activities of private trusts and cartels, not the public sector. In the 1943 *Parker* ruling, the Supreme Court affirmed that states were free of antitrust scrutiny. It was assumed that local governments were similarly immune.

But in its 1978 plurality decision in *Lafayette*, the Court brought local government activities under the reach of this body of law. In the most pub-

licized case in this regard—*Boulder* (1982)—the Court ended any automatic immunity enjoyed by localities by ruling that home rule by itself does not constitute a sufficient grant of authority for local governments to act anticompetitively.

Local governments are now being sued with increasing frequency for licensing, franchising, zoning, and regulatory decisions that by definition displace or restrain competition. These cases are resulting in large costs even when local governments win. A case recently lost by a local government will cost it \$28.5 million unless the decision is overturned. Concerned with the growing costs to local governments, both in terms of finances and their ability to govern, committees in both houses of Congress held hearings on this issue within the last few months.

The Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary held hearing on March 29 on three bills introduced by members of that Subcommittee aimed at providing relief to local governments. Presided over by Rep. Peter Rodino, chair of the Committee, and the bills' authors—Representatives Edwards, Fish, and Hyde, respectively—the witnesses provided strong testimony, though few surprises. The testimony of state and local officials representing the National Association of Attorneys General (NAAG), the National League of Cities (NLC), the National Association of Counties (NACo), the National Institute of Municipal Law Officers (NIMLO), and the National Conference of State Legislatures (NCSL) closely followed the position of their associations, further underscoring the sharp differences on this issue between the state and local levels (see *Intergovernmental Perspective*, Fall 1983).

Most important, perhaps, was the opening statement by Rep. Rodino in which he asserted several limits or legislative approaches to this problem. In setting the context for this hearing, he questioned whether the Supreme Court's ruling in *Boulder* "... truly represents a bold new departure, or merely a clarification of

developments long in the making. . . ." Further, Rodino stressed that any legislative solution would face the problem of offering

. . . some measure of protection to local units without running afoul of the Tenth Amendment and its admonition to the federal branches of government to avoid interfering unnecessarily into the relationship between the States and their political subdivisions.

Congressman Rodino also noted that State immunity is not absolute, thus a state cannot exempt "... private conduct which is violative of the antitrust laws simply by authorizing it."

The hearing before the Senate Judiciary Committee on April 24 enabled a number of Senators, the Administration and others to clearly state their positions. Senator Thurmond, Chairman of the Committee and author of the bill on which this hearing focused, began by stating that "... a legislative response to *Boulder* is necessary." His emphasis on rapid congressional action to protect local units stands in sharp contrast to a statement he made nearly two years ago that congressional action would await state and local agreement on the appropriate solution.

Mayor Joseph Riley of Charleston, South Carolina, a member of ACIR, testified on behalf of the NLC and underscored the threat to local finances and governance capabilities posed by their exposure to numerous and costly antitrust suits. The mayor caused a stir by noting a pending antitrust suit against a village of about 600 people in Colorado for roughly \$850 million—more than \$140,000 per village resident. He extrapolated that a comparable suit against the U.S. as a whole would seek in excess of \$35 trillion! To remedy this situation Mayor Riley urged that Congress amend the antitrust laws to provide a broad immunity for localities similar to that enjoyed by the states.

Juggling Intergovernmental Revenue Concerns

by Robert J. Kleine

Government watchers have documented the rise, distribution, and decline of federal intergovernmental aid. Washington's regulation of state and local activities has also been examined. The judiciary's role likewise has been scrutinized and its impact on the federal system substantiated. Little noted, however, are the complex webs of tax interrelationships and how the search for revenues to finance the three levels of government leads to competition for tax dollars.

Table 1 shows how the national government dominates the total revenue system although its position has declined relatively over the last 20 years. Large federal tax cuts in the last three years and a flurry of tax activity at the state-local level have combined to reduce the federal share, but the national government still collected 61.7% of all government receipts in 1983. Given the need to reduce the deficit and to finance entitlement programs, the federal share may begin rising again.

This article reviews various revenue-raising proposals with particular attention given to their intergovernmental dimensions. This review, however, in no way constitutes an endorsement of any of the tax changes discussed. Rather, as the boxed information on page 9 of this **Perspective** illustrates, the Commission voted against raising specific taxes and favors applying the revenues from any additional taxation strictly to reducing the deficit. The Commission further urges that Congress consider a wide array of approaches to move toward budgetary balance, including: expenditure cuts; a separate capital budget; a line-item veto; and, a constitutional mechanism to ensure balanced budgets.

Four tax policy issues are of special concern to state and local governments: continued federal deductibility of state and local taxes, the tax-exempt status of interest on municipal bonds, the possibility of a national consumption tax, and federal re-entry into the excise tax field.

THE FOOT IN THE DOOR

Conflict between the three levels of government over the revenue pie is not new but it is now growing in intensity. Two major federal tax actions since 1981 have already had a significant impact on state and local revenue-raising abilities and may foreshadow further

GOVERNMENT RECEIPTS, BY LEVEL OF GOVERNMENT SELECTED YEARS, 1954-1983 (Percent Distribution)

	Federal ¹	State	Local
1954	70.9%	14.9%	14.1%
1959	69.4	15.6	15.0
1964	66.0	17.4	16.6
1969	66.4	18.5	15.2
1974	63.2	20.9	15.9
1979	64.5	21.6	13.9
1980	64.5	21.7	13.7
1981	65.5	20.9	13.4
1982	63.5	22.2	14.4
1983 (est.)	61.7	23.1	15.2

¹Includes social insurance contributions.

Note: Percentages may not equal 100 because of rounding.

Source: ACIR, **Significant Features of Fiscal Federalism, 1982-83 Edition**, M-137, January 1984, Table 22.

ACIR's Tax Policy

At its March meeting in Phoenix, Arizona, the Advisory Commission on Intergovernmental Relations adopted the following recommendations regarding federal revenue actions to reduce the budget deficit.

- (1) **FISCAL DISCIPLINE**—The Commission desires to make clear that its recommendations concerning the intergovernmental implications of any action to strengthen the federal revenue system are coupled with two additional recommendations for building greater fiscal discipline into the federal budget process:
 - that the deficit be steadily reduced and that until the budget is balanced revenues generated by any additional taxation be applied only to reducing the deficit; and
 - that to move toward budgetary balance as quickly as possible, Congress give attention to the widest array of approaches available to achieve balance—including expenditure cuts, a separate capital budget, a line-item veto, and a constitutional mechanism to ensure balanced budgets.
- (2) **PRIOR CONSULTATION**—The Commission recognizes that the federal tax system could be restructured in ways that would affect state and local funding. The Commission recommends, therefore, that national policymakers consult extensively with state and local elected officials before charting any major new course for federal revenue policy.

In particular, broad federal income tax reform which reduces or eliminates a wide range of tax benefits may substantially restrict two provisions of the present income tax that provide fiscal assistance to state and local governments—deductibility of state and local taxes and the tax exemption of interest on state and local bonds. Therefore, such federal tax reform and revenue raising efforts should include explicit consideration of potential harm to state and local ability to raise revenues and to borrow funds.
- (3) **NO INCREASE IN FEDERAL SELECTIVE EXCISE TAXES**—The ACIR has concluded that the benefits the national government would derive from increasing selective excise taxes would be more than offset by the negative effects such actions would have on state and local revenue-raising ability. The Commission recommends that Congress resist pressure to increase federal reliance on selective excise taxes.
- (4) **OPPOSITION TO FEDERAL VAT**—The Commission concluded that a major intrusion into the consumption tax field by the federal government would restrict the ability of state and local governments to increase their sales taxes, would provide a powerful new engine for federal spending, and would reinforce the centralization and fiscal dominance of the national government at the expense of state and local governments. The Commission therefore recommends that the federal government refrain from enacting a major consumption tax as an additional revenue source or as a replacement for other federal taxes.
- (5) **RETAIN INDEXATION**—The Commission reaffirms its support for indexing the federal personal income tax. If and when Congress raises income taxes, the tax increase should be the consequence of direct legislative action and not the result of inflation-induced bracket creep.
- (6) **NO VOLUME CAPS ON TAX-EXEMPT BONDS**—The Commission concludes that state and local interests in issuing tax-exempt bonds for private forms of economic development must be balanced against federal aversion to financing private projects that are widely viewed as not deserving federal assistance. The Commission opposes the imposition of new federal volume caps. It recommends, however, that Congress build on the reforms enacted in *TEFRA* by: (1) eliminating tax-exempt financing for projects that do not merit federal assistance or that do not contribute to economic development; (2) eliminating certain opportunities for “double-dipping” in which private businesses benefit from federal tax benefits in addition to tax-exempt financing; and (3) limiting the total amount of “small issue” IDB’s allowed any one user. The Commission noted, however, that these restrictions should not apply to residential housing bonds and economic development bonds for distressed communities.

conflicts. The first was the new Accelerated Cost Recovery System (ACRS) depreciation method, contained in the *Economic Recovery Tax Act of 1981*, which affected most state corporate income tax collections. Second, excise tax increases on cigarettes and gasoline in 1982 ended the national government's long hiatus from the excise tax field.

ACRS—To Decouple or Not: That Was the Question.

The *Economic Recovery Tax Act of 1981* was the most far reaching change in the tax system since World War II. Several provisions in this legislation affected state and local revenues. The most significant of these changes, ACRS, has already reduced state and local revenues by more than a billion dollars and will continue to depress revenues through 1986. Since its enactment states have had to decide whether to follow the new federal provisions. A number of states have decided to disallow all or a portion of ACRS. (See the listing in Table 2.)

The revenue loss was a major concern to state and local officials, but not the only concern. The inattention to the intergovernmental implications of the 1981 legislation gave governors and mayors reason to take a much harder look at the advantages and disadvantages of close conformity with the federal tax code.

Federal Re-entry into the Excise Tax Field. After two decades of relative indifference to selected excise taxes, the national government stepped up its use of these revenue sources. In 1982 the federal cigarette excise tax was doubled from 8 cents per pack to 16 cents, effective January 1, 1983 (to revert to 8 cents in September 1985), the first increase since 1951. In the intervening years the states took full advantage of federal inaction in the cigarette tax field as the state share of total federal-state cigarette collections increased from 25.5 percent in 1951 to 61.1 percent in 1982. Renewed federal interest in selective excise taxes is especially surprising because President Reagan in early 1981 specifically mentioned these tax sources as part of his effort to turn back revenues and expenditure responsibilities to state and local governments.

Subsequently the *Surface Transportation Assistance Act of 1982* raised the federal excise tax rate on gasoline from 4 cents to 9 cents per gallon, the first increase since 1959. During this period state governments raised the motor fuel rate from an average of 4.65 cents per gallon in 1950 to 9 cents per gallon in 1982. In 1983, state taxes on motor fuel ranged from a low of 5 cents in Texas to 17 cents in Minnesota.

The alcoholic beverage tax was the only major selective excise tax that was spared in the 1982 legislation, but legislation currently moving through Congress would raise that tax too, with the proceeds used to reduce the federal budget deficit. Other legislation recently passed in the House would retain 4 cents of the 8-cent cigarette tax increase on a permanent basis. State-local reactions to the cigarette excise tax increase were different than those to the gasoline excise tax in-

Table 2
Status of Accelerated Cost Recovery System
for
State Corporation Income Taxes at End of 1983

ACRS Allowed	Part of ACRS Allowed	ACRS Not Allowed
Alabama	Arkansas	California
Alaska (1)	Connecticut	Georgia
Arizona	Florida	New Jersey
Colorado	Kentucky (4)	(4)
Delaware	Maine (4)	New York
Hawaii	Minnesota (4)	Oregon
Idaho	North Dakota (5)	
Illinois	Ohio (4)	
Indiana	Pennsylvania (4)	
Iowa	South Carolina	
Kansas	Tennessee	
Louisiana	Virginia	
Maryland	West Virginia	
Massachusetts		
Michigan (2)		
Mississippi		
Missouri		
Montana		
Nebraska		
New Hampshire		
New Mexico		
North Carolina		
Oklahoma		
Rhode Island		
Utah		
Vermont		
Wisconsin (3)		
District of Columbia		

(1) Depreciation for oil and gas producers and pipelines is computed on the basis of section 167 of the Internal Revenue Code as that section read on June 30, 1981.
(2) No corporation income tax. ACRS allowed for personal income tax. Depreciation not relevant for single business tax.
(3) ACRS not available for public utilities nor for property located outside the state.
(4) ACRS allowed in full for individuals.
(5) Individuals filing the short form are allowed ACRS in full.

Source: Federation of Tax Administrators, *Tax Administration News*, Vol. 48, No. 2, February 1984.

crease. Proceeds from the cigarette tax were not shared with state and local governments, but a portion of the new gasoline tax revenues was earmarked to maintain and construct state highways and roads. Understandably, preemption appears more tolerable when federal revenues are shared, but it may remain an important concern even when states and localities are spared the burden of raising taxes for specific purposes. Another threat to state-local use of selective excise taxes comes from a different direction. The Advisory Council on Social Security has urged Congress to raise federal excise tax rates on alcohol and tobacco and to earmark these revenues to cover a portion of the projected \$200 to \$300 billion Medicare budget deficit ex-

pected to accumulate by 1995. This recommendation proposes a distinct departure from past social security financing practices. When faced with past shortfalls, the national government increased tax rates or broadened the tax base. But the numerous social security tax hikes in recent years and waning public support now make it increasingly unpopular to move in that direction.

The Social Security/Medicare financing problem combines with the massive federal budget deficit to pose a major threat to state-local use of excise taxes. A dramatic increase in federal excise taxes would not only make it more difficult for state and local governments to raise these taxes, but would also reduce consumption of the taxed items and hence decrease the revenues available to the state-local sector. Excise taxes have been used in the past to close small gaps in state budgets at relatively little political cost; state officials will be unhappy if large national increases take away these "easy" revenue sources.

THE CURRENT PROBLEM: CONFLICTING ALTERNATIVES

Large national budget deficits create problems for federalism in two fundamental ways. First, if the deficit is not reduced, public and private-sector competition for funds will push up interest rates and slow economic growth. Evidence is mounting that "crowding out" is beginning to occur as private credit demands expand with economic recovery. Three-month Treasury Bill rates increased from 8.7 percent in November 1983 to almost 10 percent in April 1984. High interest rates were largely responsible for the recessions in 1980 and 1982 which created the most serious fiscal problems for state and local governments since the 1930s. The extended economic downturn forced state and local governments to make deep budget cuts, enact large tax increases and use up surpluses and "rainy day" funds. These governments are in a weak position to face another financial crisis if the economic recovery falters during the next year.

Second, actions to reduce the national budget deficit may involve expenditure reductions and tax increases that will almost certainly have an immediate impact on the fiscal condition of state and local governments as well as a longer-range impact on their revenue raising capabilities. Of particular concern to state and local governments are the potential impacts of federal tax changes on the deductibility of state and local taxes, tax-exempt bonds and tax "headroom," especially with respect to consumption and excise taxes. The next section discusses the various federal revenue options in the context of these state-local issues. These options are summarized in some detail in Tables 3 and 4.

Among the options discussed, delaying indexation and imposing a surtax on incomes would have the least disruptive intergovernmental effects. Two options, broadening the base of the income tax and adopting a flat-rate income tax have perhaps the greatest potential to affect states and localities. The final option discussed, adopting a national consumption tax, falls in

the murky middle. In the latter case, the inter-governmental impact depends to a large degree on the type of consumption tax adopted, how high the rate is, and how the tax is designed and collected.

Delay or Repeal Indexation of Federal Income Tax. Eliminating indexation which is scheduled to begin on January 1, 1985 would reduce the budget deficit by an estimated \$17 billion in FY 1986 and by \$65 billion in FY 1989. Some state and local officials favor delaying or repealing indexation because it would do the least damage to state and local fiscal interests. Although higher federal income tax rates could increase public resistance to state-local tax increases (particularly income taxes), higher national rates would increase the value of items which are tax deductible and of the interest exemption accorded municipal bonds. On balance, therefore, it would be far less disruptive to state and local interests than the other major revenue alternatives—broadening the income tax or enacting a new tax. Indexation's proponents, including ACIR, base their support on four major considerations:

- **Fiscal Accountability**—Indexation insures that higher effective income tax rates are the product of overt legislative action rather than the automatic consequence of inflation.
- **Tax Equity**—Increases in tax liability should be based on real rather than nominal income changes.
- **Public Sector Growth**—Without indexation there is a bias toward expanding the public sector because inflation automatically pushes taxpayers into higher tax brackets, generating unlegislated revenues.
- **Fiscal Imbalances**—Without indexation, inflation aggravates intergovernmental fiscal imbalances because the national government is the primary beneficiary of "bracket creep."

Impose Surtax on Individual and Corporate Income Taxes. A 10 percent surtax would raise about \$41 billion annually and would have roughly the same impact on state and local governments as repeal of indexation. High federal income taxes would, as discussed above, have some positive intergovernmental effects but would probably stiffen resistance to raising state and local taxes even more than would repealing indexation.

The major problem with the surtax, as with repeal of indexation, is that it does nothing to address the economic and tax-equity weaknesses of the federal income tax. In fact, it exacerbates these weaknesses.

Broadening the Base. Proposals to broaden the base of the personal income tax would make a fundamental change in that tax, eliminating many if not most items of tax preference (i.e., exclusions, deductions, exemptions, and credits). The amount of revenue generated would depend on the specifics of the proposal—the most commonly discussed proposals would increase revenue about \$45 to \$50 billion annually. (See Table 4 for an enumeration of many of the tax preferences that would

Table 3

Major Revenue Proposals For Reducing The Federal Budget Deficit—A Comparative Analysis

Tax and Description	KEY POLICY CONSIDERATIONS										
	EFFECTS AT FEDERAL LEVEL							EFFECTS AT STATE-LOCAL LEVEL			
	Political	Administrative	Economic	Tax Equity				Fiscal		Threatens S-L Sales Tax Position?	
	Ease of Implementation ¹	Effect on Political Accountability ¹	Effect on Ease of Taxpayer Compliance	Effect on Capital Formation Incentives?	Effect on Work Incentives?	Effect on Economic Distortions?	Effect on Progressivity?	Effect on Horizontal Equity?	Effect on Value of S-L Tax Deductibility?	Effect on Tax-Exempt Bond Status?	
INCREASE TAX RATES											
1. Repeal individual income tax indexing	fair to good	very poor	no change	no change	slightly weakens	slightly worse	slightly reduces	slightly worse	enhances value	enhances value	no
2. Add 10% surtax to individual & corporate income tax	fair to good	good	no change	slightly weakens	slightly weakens	slightly worse	no change	slightly worse	enhances value	enhances value	no
BROADEN BASE OF INDIVIDUAL INCOME TAX											
1. Close major tax loopholes (no tax rate reduction) ²	fair to good	fair	slightly improves	no major change	no major change	slightly improves	no major change	slightly improves	major weakening	major weakening	no
2. Switch to modified flat rate income tax	fair to poor	good	considerably improves	slightly weakens	considerably improves	considerably improves	slightly reduces	considerably improves	major weakening ³	major weakening	no
3. Switch to a comprehensive, flat rate income tax	very poor	good	greatly improves	slightly improves	greatly improves	greatly improves	greatly reduces	greatly improves	complete elimination	complete elimination	no
ENACT NEW CONSUMPTION-TYPE TAX											
1. Add a broad-based energy tax	fair to good	good	no change	no change	no change	no major change	slightly reduces	no major change	no change	no change	no
2. Add a Value-Added Tax (consumption-type) to current law ⁴	poor	poor to good ⁵	no change ⁶	slightly improves	no change	no major change	slightly reduces	no major change	no change	no change	possibly ⁷
3. Switch to a personal expenditure tax	very poor	good	greatly improves	greatly improves	considerably improves	greatly improves	slightly reduces	considerably improves	complete elimination	complete elimination	no

Source: ACIR staff, April 16, 1984.

¹On a scale of 1 to 4, very poor = 1, poor = 2, fair = 3, and good = 4. "Fair to good" and "fair to poor" occupy intermediate positions. See also Note 5.

²Refer to Table 1 for a complete listing of selected tax loopholes. From that selection, the largest revenue sources would be: eliminating the exclusion for private-purpose tax-exempt bonds, repealing deductibility of consumer interest payments, taxing 50% of Social Security benefits, repealing the state and local sales tax deduction, and taxing some employer-paid health benefits.

³Complete elimination of the sales and personal property deduction coupled with a major reduction in the value of the real property and personal income tax deductions.

⁴Assumes that virtually all of additional revenue obtained from the tax will be used for deficit reduction and not as a supplement for the elimination of any existing federal tax.

⁵"Poor" accountability if the tax is hidden; "good" political accountability if the total tax is stated separately at the retail level.

⁶Ease of tax compliance will be unchanged for individual taxpayers, although business taxpayers may find tax administration more complex, depending on its exact form.

⁷The seriousness of the threat is determined largely by the height and visibility of the tax. A VAT with a relatively high rate, say 8%, that is stated separately at the retail level would be highly restrictive. Conversely, a VAT with a relatively low rate, say 3%, that is hidden in the retail price would be far less restrictive.

likely be eliminated.) Two of the items frequently targeted for elimination are that state and local sales tax deduction and tax-exempt interest on private-purpose municipal bonds.

Removing the sales tax deduction would, in effect, increase the sales tax burden on state and local taxpayers by \$3.6 billion, or 7 percent. The incidence of this change, however, would be progressive because the impact would be heaviest on taxpayers in higher tax brackets. Low-income taxpayers would generally not be affected; only 8.4 percent of all taxpayers with Adjusted Gross Incomes of \$15,000 or less claimed the sales tax exemption in 1981.¹

Eliminating the tax-exempt status of private-purpose municipal bonds would inhibit an important tool for economic development. However, all states and localities would be affected so no single entity would be placed at a competitive disadvantage. Furthermore, removing the tax-exempt status might reduce the volume of such bonds and lower the interest costs on public-purpose tax-exempt bonds. The report of the Committee on Ways and Means of the U.S. House of Representatives on the Tax Reform Act of 1983 observed:

... the committee is concerned that the expanding volume of private-activity bonds has inflated tax-exempt interest rates, thereby increasing the costs of state and local borrowing for traditional public purposes (schools, roads, public projects, etc.). Competition from private-activity bonds may thus force state and local governments to choose between raising taxes, in order to meet increased borrowing costs, or providing a lower level of services.²

Broadening the federal tax base offers one important advantage for state and local governments. The income tax bases of most states and cities are closely tied to the national government's definition of "income." An increase in the federal income tax base would result in higher revenues for state and local governments.

From a tax policy standpoint, broadening the base of the national income tax would ease taxpayer compliance and treat equals more equally.

The Flat Rate Income Tax. The flat-rate income tax has generated considerable interest in recent years and has been put forward in several legislative proposals. The Bradley-Gephardt proposal named for its chief sponsors, Senator Bill Bradley and Representative Richard Gephardt, has probably attracted the most attention and for that reason its provisions provide the basis for this analysis of the flat rate option.

This proposal is a modification of a pure flat-rate income tax in that several tax preferences would be retained and there would be four tax brackets with a maximum rate of 30 percent.

The interest in a flat-rate income tax is sustained by widespread public belief that the federal personal income tax is badly flawed. This strong feeling is documented by ACIR's 1983 public opinion poll. For the fifth year in a row, the federal income tax received more "votes" than any other major tax when respondents were asked "Which do you think is the worst tax—that is, the least fair?" (See Table 5.)

The public's aversion to income taxes can be explained by examining responses to two other questions in the ACIR poll. When asked: "If federal tax collections must be increased, which way is best?" 39 percent of the respondents chose cutting back on all itemized deductions. Raising tax rates was the second choice, favored by 21 percent of those surveyed. The survey also asked: "Which one change would make the tax system more fair: (1) Make upper income taxpayers pay more, (2) Reduce taxes on lower income persons, (3) Make business pay more, or (4) Leave the tax system alone?" The first choice, selected by 49 percent, was to make upper income taxpayers pay more. The fourth choice—leave the tax system alone—was selected by 15 percent of those surveyed.

The poll results indicate that the federal income tax is unpopular because it is perceived as complex and unfair. Taxpayers believe that there are too many loopholes and that these loopholes are used by the rich to unfairly reduce their tax liability. Although these abuses may not actually be widespread, the perception exists and it is strengthened by the complexity of the federal income tax.³ The fact that people earning the same income can be treated very differently under the federal tax code fosters public hostility. This differential treatment is highlighted by comparing the relatively higher tax liabilities of persons who save their money with those who borrow heavily, deduct interest payments and hence lower their tax liability. In addition to the revenue foregone through legal deductions, tax preferences may also encourage tax evasion. The IRS estimated that the national treasury lost \$87 billion through evasion in 1981. The entire system has become so complex that taxpayers are spending about \$9 to \$10 billion annually preparing their returns.⁴

To summarize, a flat-rate income tax, whether comprehensive or modified, is appealing because, by eliminating tax preferences, equals are treated more equally, economic distortions are reduced and the whole process is vastly simplified. Such a change could help restore taxpayer confidence in the tax system and reduce evasion. Lower rates might also improve work incentives, increase incentives for capital formation and contribute to reducing tax evasion. These beneficial effects might be realized despite eliminating tax preferences aimed at encouraging investment, such as Individual Retirement

¹Individual Income Tax Returns, **Statistics of Income**, 1981, Tables 1.1 and 2.1.

²**Tax Reform Act of 1983**, Report of the Committee on Ways and Means, U.S. House of Representatives on H.R. 4170, Vol. 1, 1983, p. 375.

³Internal Revenue Service data for 1980 indicate that 96 percent of taxpayers earning \$100,000 or more a year (and claiming a deduction for state and local taxes or mortgage interest) had a marginal tax bracket of between 50 percent and 70 percent.

⁴Robert E. Hall and Alvin Rabushka, **Low Tax, Simple Tax, Flat Tax**, McGraw-Hill, 1983, p. 6.

A Comparative Description Of The Major Revenue

Tax Change	Estimate of Additional Revenue for FY 85 in billions* (Source)	Total FY 85 to FY 89 Revenue Estimate in billions	Tax Rate	Tax Base
INCREASE TAX RATES	\$17 (CBO, FY 86)	\$165	N/A	Adjusting the individual income tax to changes with Consumer Price Index is scheduled to begin January 1985. Under indexation, income tax brackets, standard deduction, and personal exemptions will be adjusted to annual inflationary economic changes.
1. Repeal individual income tax indexing				
2. Add surtax to individual & corporate income tax	\$39 (CBO)	\$230-245	10% surcharge	Existing individual and corporate tax base would be used with a 10% surcharge placed on tax liability.
BROADEN BASE OF INDIVIDUAL INCOME TAX	\$25 (ACIR based estimates from CBO & OMB)	\$170-210	No change	Under the Tax Equity and Fiscal Responsibility Act of 1982, numerous minor tax changes were made to raise large amounts of revenue. The revenue estimates assumes closing the following commonly discussed tax preferences (loopholes); tax 50% of social security and railroad retirement benefits over a specified threshold; tax unemployment compensation & workmen's compensation benefits; limit mortgage interest deductions to only primary residences; repeal charitable contributions for non-itemizers; eliminate the tax-exempt status for newly issued private-purpose state-local bonds; and repeal state & local sales tax deductions.
1. Close major tax loopholes (No change in tax rates)				
2. Switch to modified flat rate tax	\$45 (ACIR estimates assuming a 15% surtax)	\$225-250	14% up to \$40,000 26% \$40,001-\$65,000 30% over \$65,000 (for joint returns)	Under the current Bradley-Gephardt proposal, there would be a base tax rate of 14% and two surtax rates of 12% and 16% depending on income level. The personal exemption would rise to \$1,600 for each taxpayer and the standard deduction would be \$3,000 for single taxpayers and \$6,000 for married taxpayers. This measure would greatly broaden the income tax base, but retains the popular deductions for interest paid on home mortgages, charitable contributions, large medical expenses, and state and local income and real property taxes. These deductions, however, apply only to income taxed at the 14% rate.
3. Switch to a comprehensive, flat rate income tax	\$45 (CBO)	\$225-\$250	22%	A flat rate tax would provide one tax rate for all taxpayers and eliminate all tax preferences. To match current individual income tax receipts of about \$300 billion, CBO assumptions are based on a 19% tax rate and raising the personal exemption to

Proposals For Reducing The Federal Deficit

Tax Change	Estimate of Additional Revenue for FY 85 in billions* (Source)	Total FY 85 to FY 89 Revenue Estimate in billions	Tax Rate	Tax Base
				<p>\$1,500 from \$1,000 and the zero bracket amount to \$3,000 for single tax filers and to \$6,000 from \$3,400 for joint returns. Assuming a 15% increase (or \$45 billion) in revenue was desired, a 22% tax rate would be required.</p>
<p>ENACT NEW CONSUMPTION TYPE TAX</p>	\$11 (CBO)	\$83	5%	<p>A broad-based energy consumption tax would tax domestic & imported energy, including petroleum, natural gas, coal, hydroelectric & nuclear power. The CBO revenue estimate is based on the value of energy produced, but alternative approaches could include taxing the units produced (such as tons or barrels) or the amount of heat content produced by each energy source measured by British Thermal Units (BTUs).</p>
<p>1. Add a broad-based energy tax</p>				
<p>2. Add a Value-Added tax (consumption type)</p>	\$54 (ACIR)	\$310-340	3%	<p>A value-added tax is a tax on the value that a stage of production adds to a product. This added value is the sales price of the products sold, minus the purchase price of the inputs or raw materials used in production. The tax is levied at each stage of production and during resale. A consumption-type VAT would show the amount of VAT to be paid by the consumer separate from the selling price of the product. This tax would share certain characteristics with a state sales tax. A VAT can be devised to exclude from taxation business capital formation expenditures.</p>
<p>3. Switch to a personal expenditure tax</p>	\$43-61 (Brookings)	\$215-305	<p>Similar to current income tax system</p>	<p>A personal expenditure tax is similar to an income tax, but rather than taxing income earnings, it would tax individuals' spending & exempt from taxation savings & investment. The tax rates, personal exemption, & zero bracket amount can be formulated to be progressive. The major source of additional tax revenue would be derived from eliminating most tax preferences now in the federal tax code.</p>

*Revenue estimates from the Congressional Budget Office and the Office of Management and Budget were made in February 1984.

Source: ACIR staff (March 20, 1984).

Accounts, accelerated depreciation, and favorable treatment of capital gains.

The flat-rate income tax still has serious drawbacks, particularly a comprehensive one. First, there are serious transition and political problems. For example, eliminating the deduction for charitable contributions could hurt charities and eliminating the deduction for mortgage interest would create financial problems for many homeowners by sharply increasing the overall costs of homeownership and reducing the value of their homes. Second, the benefits would be greater for high-income taxpayers because their marginal rates would probably drop the most, thereby reducing the progressivity of the federal income tax. Finally, eliminating tax preferences or reducing marginal tax rates, or doing both, would have serious implications for state and local governments. A comprehensive flat-rate income tax would eliminate the tax-exempt status of interest on municipal bonds and the deductibility of state and local taxes, thus raising interest costs for state and local governments and increasing the burden of state and local taxes. A modified flat-rate proposal (such as the Bradley-Gephardt bill) avoids this first inter-governmental pitfall by retaining the tax exempt status for interest on general obligation (GO) bonds deemed for "public purposes." However, this distinction between types of tax-exempt bonds could create problems for those governments that issue revenue rather than (or in addition to) GO bonds. Bradley-Gephardt also retains the deduction for state and local income and property taxes but would eliminate sales and personal property tax deductions. Even a modified flat-rate tax such as Bradley-Gephardt would have intergovernmental effects—it could, for instance, encourage state-local income taxes relative to sales taxes. Also, the lower marginal tax rates in Bradley-Gephardt and other flat-rate proposals would reduce the value of deductibility and of the tax-exemption for municipal bond interest. In fact, the proposal provides for these deductions to be claimed at the lowest tax rate, 14%.

The flat rate proposals would not, of course, restrict state use of sales and excise taxes. In addition, in those states and localities where income taxes closely follow federal definitions, increased income tax revenues resulting from the broadened federal income tax base might actually reduce the need for state and local tax increases.

Value-Added Tax (or Other Consumption Taxes).

The value-added tax (VAT) or other consumption-based taxes such as a national sales tax or a personal expenditure tax are appealing as a national revenue source because large amounts of revenue can be raised at low rates (\$19 billion per one percent in 1985). Furthermore, taxes on consumption are viewed as more conducive to saving and investment than are taxes on income. The VAT is also attractive to economists because it is neutral: that is, all factors of production and all forms of business are taxed equally. This neutrality reduces the importance of taxes in the business decision process and minimizes economic distortions.

The value-added tax is imposed on the value a firm adds to the goods it purchases from other firms. The firm adds this value by using its labor force, machinery, buildings, and capital to handle or process the goods and services it purchases. Value added is the difference between a firm's sales and its purchases, or alternatively, the sum of its labor costs, profits, rent, interest, royalties and other operating costs.

Although the VAT is an attractive revenue source, it has several weaknesses that make quick adoption at the national level unlikely. First, critics argue that all consumption taxes are regressive because low-income persons spend a higher percentage of their income than do high-income persons. Second, some fear that the VAT could be a powerful engine for increased federal spending because its broad base enables a low rate to generate substantial revenues. Third, many businesses may oppose a VAT because it is not based on ability-to-pay and it would cover many unincorporated firms not accustomed to paying business taxes. Fourth, and of particular relevance to this article, state and local officials fear that a national VAT could limit their ability to raise sales taxes. A VAT is generally viewed as a form of retail sales tax, and its use at the national level might affect public acceptance of higher sales taxes at state and local levels. How restrictive a federal VAT might be will be determined largely by two factors—its rate and its visibility. For example, a VAT with a relatively high rate of say 8 percent that is stated separately at the retail level would be highly restrictive. Conversely, a VAT with a relatively low rate (say 3 percent) that is not stated separately but is hidden in the retail price would be far less restrictive.

Interestingly, ACIR opinion polls have found that the

Table 5

Which Do You Think Is The Worst Tax—That Is, The Least Fair?

	May 1983	May 1982	Sept. 1981	May 1980	May 1979	May 1978	May 1977	May 1975	April 1974	May 1973	March 1972
Federal Income Tax	35%	36%	36%	36%	37%	30%	28%	28%	30%	30%	19%
State Income Tax	11	11	9	10	8	11	11	11	10	10	13
State Sales Tax	13	14	14	19	15	18	17	23	20	20	13
Local Property Tax	26	30	33	25	27	32	33	29	28	31	45
Don't Know	15	9	9	10	13	10	11	10	14	11	11

Source: ACIR, 1983 Changing Public Attitudes on Governments and Taxes, S-12, 1983, p. 1.

Description of Michigan VAT

The only state that levies a value-added tax (VAT) is Michigan. The Michigan VAT took effect on January 1, 1976, and replaced seven other business taxes, including the corporate income tax, the corporate franchise tax, and personal property taxes on inventories. Because the VAT is the only major business tax in Michigan, other than the local property tax, it is known as the Single Business Tax.

The Michigan VAT is of the modified, consumption type and is calculated using the additive method. The taxpayer begins with federal taxable income and adds to it the other components of value-added: compensation, interest paid, depreciation, royalties paid, and dividends paid. A full deduction is allowed for capital investment each year. There is a \$40,000 small business deduction (which is phased out as profits increase), a credit for firms with gross receipts of \$3,000,000 or less and low profits, a deduction for firms with compensation costs in excess of 63 percent of the tax base, and a limit on the tax base of 50 percent of gross receipts for all firms. The original legislation included a number of special transition deductions that have been largely phased out. The tax is collected in four quarterly payments and an annual settlement. The rate is 2.35 percent, which has not changed since the tax was enacted.

The yield of the tax in its first full year, FY 1977, was \$803.5 million. The yield in FY 1983 was \$999.7 million and the estimate for FY 1984 is \$1.135 billion.

tax, which looks very much like an income tax, would probably not have a restrictive effect on sales taxes, but a national sales tax, which directly competes with state sales taxes, could be highly restrictive.) Finally, the tremendous productivity of the VAT could reduce the tax's restrictive nature because a low rate could raise substantial revenues while minimally interfering with state and local sales taxes.

CONCLUSION

Resolving the federal deficit problem will undoubtedly involve tradeoffs among many competing interests. A proposal that constitutes good tax policy may appear less desirable when its intergovernmental impacts are carefully weighted. No proposal has yet been advanced that can address all the problems of our intergovernmental system without creating other problems.

By their very nature, the goals of comprehensive taxation conflict with the goals served by various tax preferences. From the intergovernmental viewpoint, most important are the potential threats to the deductibility of state and local taxes and to the exclusion of interest on municipal bonds. Also of concern are changes in the national tax system that would limit the ability of states and localities to raise revenue. However, intergovernmental concerns do not stand in isolation. Weight must also be given to the impact changes might have on equity, progressively, simplicity, capital formation, work incentives, and economic distortions.

It might seem easiest to reduce the federal budget deficit by increasing rates on existing taxes, but this approach foregoes the opportunity to make changes in the federal tax system that might well serve other important national goals, including making the tax system fairer, restoring taxpayer confidence, and removing tax barriers to economic growth. Further, to reiterate ACIR policy adopted last spring, policy makers should pay attention to the widest possible array of options to restore fiscal discipline to the budgetary process.

Achieving any of these goals without weakening the position of state and local governments in our federal system will not be easy, but national policymakers should carefully balance federal revenue needs against the many competing and conflicting federalism interests.

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American public does not have as negative a view of a broad-based consumption tax (be it a VAT or a national sales tax) as state and local officials may fear, particularly when measured against an income tax. In its 1983 poll, ACIR found that 52 percent of the public favored a national sales tax as a source for additional revenue (if revenue had to be raised), while only 24 percent favored increasing the federal income tax.

There are several ways to allay state-local fears about the VAT. One is to share the revenues with states and localities, either directly through a grant or indirectly by allowing optional local taxing authority and providing a credit for a state or local VAT. Another way to reduce state-local opposition would be to make the VAT look more like a business activities tax and less like a retail sales tax. This appearance could be given by using the additive method of calculation, adding up the components of value-added, as is done in Michigan, or by including the tax in the price rather than stating it separately. (All European countries that use the VAT, except Denmark, bury the tax in the price.) These practices may appear devious, but they would likely reduce the restrictive impact of a VAT on state and local sales taxes. (The personal expenditure

Local Finance: A Bootstraps Operation

by Stephanie Becker

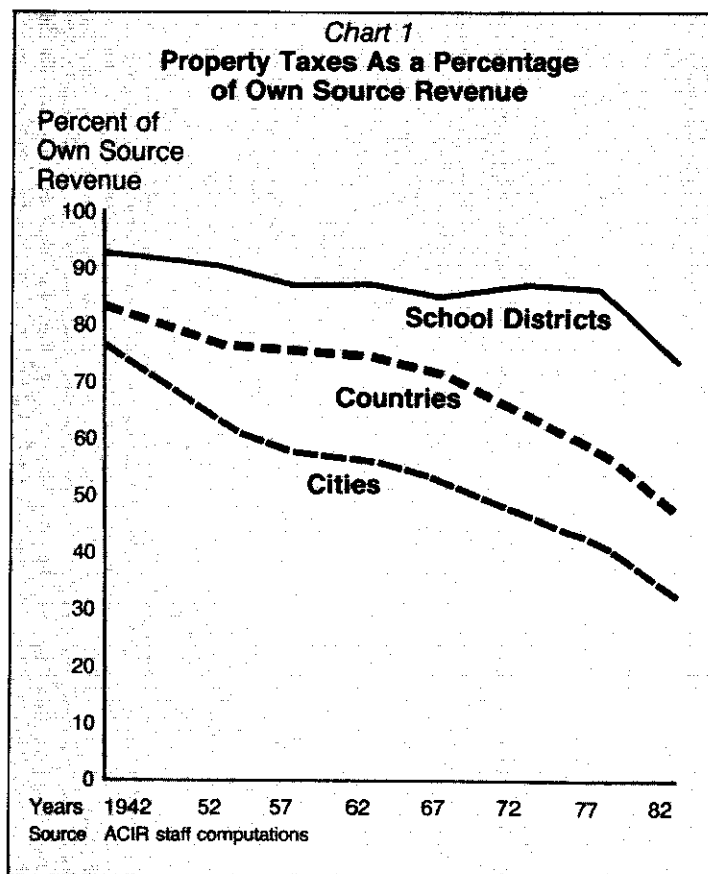
Over the past decade, three major jolts have altered the landscape of local government finance. First, local financial emergencies—particularly in New York and Cleveland—stunned the municipal community in the mid 1970s. Secondly, beginning in 1978, the taxpayers' revolt drove home the message of the public's aversion to property taxes and of a widespread desire for slower government growth. Third was the decline in federal aid, first in relative terms in the late 1970s and then in absolute terms in the early 1980s.

This article will explore the effect of these three jolts on local efforts to diversify their revenue systems. Revenue diversification began in earnest after World War II when local governments sought to reduce reliance on the property tax while increasing revenues through local sales or income taxes. This type of revenue diversification continues to the present day, but local sales and income taxes have been joined by an array of non-tax and other tax sources. Further, the revenue diversification movement has taken a new twist: revenues are increasingly viewed by local officials as not merely sources to be tapped, but something government leaders can help create.

REVENUE DIVERSIFICATION

Taxation is frequently likened to plucking a goose; in both, the object is to gain the most feathers with the least squawking. For most years in our nation's history, the favored local "feather" was the property tax which in 1932, provided about two-thirds of the funds for all local governments combined. By the beginning of this decade, that proportion had fallen to about one-quarter. Increasing federal and state aid undoubtedly was a primary factor behind the declining role of property taxes. Other influences, however, were important. Collectively they can be termed revenue diversification or "anything but property taxes."

Not all local governments have traversed the diversification path at the same speed. As Chart 1 indicates,



cities have been able to tap nonproperty revenue sources somewhat more readily than counties or school districts. However, two caveats must be kept in mind. First, national averages always conceal tremendous variations within our diverse system of fiscal federalism. Cities in New Hampshire are still extremely dependent on the local property tax—in 1982, that tax accounted for 75% of all their own-source revenue. By comparison, Alabama cities have virtually shed their property tax skin—their property tax produced only 7% of their own-source revenue in 1982.¹

The second caveat is even more important; it would be very risky to make a straight line extrapolation from past trends and predict that most cities and counties will soon be able to throw away their property tax hair shirts. In fact, although it would be misleading to infer a property tax comeback, collections have been rising. In fiscal 1982, property tax receipts climbed \$6.9 billion, the second consecutive year this revenue growth has exceeded 9%.² Although the percentage of local revenues that comes from property taxes also went up, from 30.7% in 1980 to 31.7% in 1982, the first time since World War II that this proportion rose.

Property Tax Revenues Up. A survey of the Joint Economic Committee (JEC) and the Government Finance Officers Association (GFOA) noted that increased property tax revenues were “due to the diminished importance of intergovernmental payments in total revenues.”³ Although this may be true statistically, it may also have been that the drop in federal grants, along with a decline in other tax revenues due to the recession, left local officials with little choice but to increase their reliance on property taxes or drastically reduce public services.

In fact, total local government spending either has declined or remained static for every year since 1978 when inflation is taken into account (see Table 1). When intergovernmental revenues are separated out, however, a slightly different picture emerges. Local government spending from their own revenue sources has actually increased modestly since 1979. Clearly, local governments were bearing down somewhat harder on local taxes to make up for lost federal or state money.

Further, although property taxes may be experiencing a modest renaissance, their basic unpopularity will probably preclude a return to their historic role. In each of the 12 years ACIR has polled the public on the question “Which tax do you think is the worst?” the property tax won over all other state-local taxes.⁴ In fact, for 5 years, it was judged the worst tax overall.

¹See “The Property Tax Paradox,” by John Shannon in *Intergovernmental Perspective*, Fall 1983, p. 30.

²News Release, Tax Foundation, March 20, 1984.

³John Petersen, “City Revenues: Tax Rates and Collections,” *Resources in Review*, January 1984, p. 9.

⁴1983 *Changing Public Attitudes on Governments and Taxes* (S-12), ACIR, Washington, D.C.

Table 1
**Total Local Government Spending
in per capita, constant (1972) dollars**
Including Federal & State Aid **Excluding Federal & State Aid**

1978	\$558	\$275
1979	544	266
1980	541	268
1981	526	268
1982	523	273
1983 est.	523	276

Source: ACIR.

With property taxes now increasing, the natural question is whether they will fuel similar reactions in the future. Weighing against another round of property tax-inspired rebellions is the fact that in 1983, property tax revenues, although still increasing, were not rising nearly as quickly as they did the previous two years. Also, many cities have studiously avoided property tax rate hikes; in the *National Journal* survey, for example, only four of the Nation's 25 largest cities (Baltimore, San Antonio, Indianapolis, and Milwaukee) raised property tax rates last year.⁵ In the JEC survey, only in the largest cities did the growth in property tax revenues exceed the inflation rate in 1982. Overall, the JEC data revealed that “property tax levies have not kept pace with the growth in the market value of real property, thus leading to a reduction in the effective property tax rate.”⁶

Sales and Income Taxes—Property Tax Alternatives of Choice. Given difficulties with property taxes, then, when state law has permitted (or when state authority could be obtained), localities have diversified their revenue mix. Most frequently the chosen alternative has been the sales tax. Some 6,000 jurisdictions now levy local sales taxes, compared to 4,462 in 1973. Cities rely on sales taxes to the tune of over one-quarter of their total tax revenues. Counties are not far behind with about 17% of their tax base coming from sales taxes, a proportion that nearly doubled in the 1971-81 decade. Over the same period, sales taxation by special districts—especially transit districts—climbed at an even faster clip, from 5% to 18% of their revenues.

Only slightly more than half (27) of the states, however, authorize local sales taxes, a number unchanged since 1974 when Wyoming joined the list. Within the 27 states where they are allowed, local sales taxes have gained wider acceptance and account for sizeable shares of revenues in several large cities (see Table 2).

Local income taxes are the third biggest local tax source, but their authorization is limited to only 11 states. They are, however, very important to many cities in these states. In six large cities, income taxes provide over 60% of total tax collections (see Table 3).

⁵Stanfield, Rochelle, “America's Oldest, Largest Cities Seem to Have Found a Formula for Survival,” *National Journal*, Washington, DC.

⁶Petersen, p. 9.

Table 2
Reliance On Local Sales Taxes By Individual Large Cities

City and State	General Sales and Gross Receipts Taxes as Percent of All Taxes for:	
	Fiscal Year 1971-72	Fiscal Year 1981-82
Buffalo, NY	7.2	1
Chicago, IL	14.1	16.7
Dallas, TX	19.6	27.3
Denver, CO	41.0	47.5
El Paso, TX	22.2	24.8
Fort Worth, TX	23.6	29.6
Houston, TX	25.0	29.9
Kansas City, MO	5.6	16.4
Long Beach, CA	22.5	22.3
Los Angeles, CA	19.5	23.9
Nashville-Davidson, TN	22.4	31.0
New Orleans, LA	41.2	48.5
New York, NY	13.5	17.6
Oakland, CA	22.1	20.8
Oklahoma City, OK	37.8	68.5
Omaha, NE	26.6	42.3
Phoenix, AZ	39.0	41.5
St. Louis, MO	11.7	18.5
San Antonio, TX	26.5	45.6
San Diego, CA	29.1	40.3
San Francisco, CA	13.3	11.8
San Jose, CA	23.5	30.8
Seattle, WA	14.4	14.4
Tulsa, OK	55.1	80.5

Note: "Large cities" are those with at least 300,000 residents in both 1970 and 1980 enumerations. Washington, D.C., is excluded as outside a state-local system. The large cities listed individually are those that levied a general sales or gross receipts tax in at least one of the two fiscal years: 1971-72 and 1980-81.

Source: ACIR staff compilation based on U.S. Bureau of the Census, **City Government Finances in 1971-72** (GF72, No. 4, Table 7) and **City Government Finances in 1981-82** (GF82, No. 4, Table 7).

¹Buffalo rescinded its sales tax.

Although income tax revenues have increased somewhat, from 4.6% in FY 72 to 5.8% of all local taxes in FY 82, the number of local governments with this authority has risen only modestly in recent years.

Only Ohio, Alabama, Missouri, and New York allow using both local income taxes and sales taxes. But even in those few states, usage is highly restricted. In practice, only Birmingham, Kansas City, St. Louis, and New York City employ both forms of nonproperty taxation.

Revenue diversification via the two biggest revenue raisers—sales and income taxes—has obvious disadvantages as a nationwide solution to local problems. Even in those states where locals sales and/or income taxes

are imposed, voter reluctance in recent years to higher taxes has slowed (but not stopped) their growth. Local revenue diversification efforts in the late 1970s and early 1980s, then, involved casting a wider net. This net more and more frequently included user fees and benefit-based taxes.

Pay-as-you-go government. Revenues from user fees increased about three-fold from 1971 to 1981 to \$56 billion.⁷ In a May 1983 survey of over 500 municipal finance offices, ACIR found that raising user fees was the most frequently undertaken action cited (by 72% of respondents) to raise revenues. California's experience after Proposition 13 was to sharply step up user fee levies and rates—in 1977-78, California local governments derived only 13.4% of own-source revenues from fees (excluding utilities fees) but in 1980-81 the proportion was 19.5%. Whether increased fiscal pressure will spur more localities to follow California's pay-as-you-go example remains to be seen. With a few exceptions, acceptance of user fees appears to vary by region (see Table 4) and in some areas, such as New England, traditional barriers to user fees will have to shift before they can become important revenue sources.

Because user fees have increased dramatically, especially in California and other states where they have

⁷"Local Alternatives to the Property Tax: User Charges and Nonproperty Taxes." A working paper prepared for the Academy for State and Local Government, December 1983, p. 8.

Table 3
Reliance On Local Income Or Wage Taxes By Individual Large Cities

City and State	Income Taxes as Percent of All Taxes for:	
	Fiscal Year 1971-72	Fiscal Year 1981-82
Baltimore, MD	14.2	21.6
Cincinnati, OH	57.7	72.7
Cleveland, OH	47.8	72.2
Columbus, OH	78.2	83.7
Detroit, MI	35.1	47.9
Kansas City, MO	37.0	32.7
Louisville, KY	55.6	64.5
New York, NY	21.0	27.1
Philadelphia, PA	62.5	66.4
Pittsburgh, PA	16.8	24.4
St. Louis, MO	29.4	31.4
Toledo, OH	74.9	76.8

Note: "Large cities" are those with at least 300,000 residents in both 1970 and 1980 enumeration. Washington, D.C., is excluded as outside a state-local system. The large cities listed individually are those that levied an income tax in at least one of the two fiscal years: 1971-72 and 1981-82.

Source: ACIR staff compilation based on U.S. Bureau of the Census, **City Government Finances in 1971-72** (GF72, No. 4, Table 7) and **City Government Finances in 1981-82** (GF82, No. 4, Table 7).

Table 4

Local Government Current Charges Per Dollar of Local Taxes, Fiscal Years 1972-1982

State and Region	1972	1982			
U.S. Average	.22	.34	Florida	.50	0.57
New England			Georgia	.66	0.75
Connecticut	.07	0.11	Kentucky	.40	0.40
Maine	.08	0.16	Louisiana	.27	0.43
Massachusetts	.11	0.19	Mississippi	.70	1.12
New Hampshire	.09	0.11	North Carolina	.36	0.51
Rhode Island	.06	0.07	South Carolina	.49	0.66
Vermont	.06	0.09	Tennessee	.42	0.47
Mideast			Virginia	.21	0.22
Delaware	.49	0.60	West Virginia	.37	0.54
Dist. of Columbia	.17	0.10	Southwest		
Maryland	.17	0.26	Arizona	.20	0.37
New Jersey	.12	0.16	New Mexico	.65	0.55
New York	.17	0.20	Oklahoma	.41	0.44
Pennsylvania	.20	0.24	Texas	.33	0.38
Great Lakes			Rocky Mountain		
Illinois	.15	0.22	Colorado	.22	0.27
Indiana	.25	0.50	Idaho	.37	0.67
Michigan	.27	0.35	Montana	.15	0.19
Ohio	.23	0.27	Utah	.23	0.30
Wisconsin	.15	0.50	Wyoming	.43	0.33
Plains			Far West		
Iowa	.24	0.40	California	.18	0.43
Kansas	.22	0.35	Nevada	.44	0.96
Minnesota	.24	0.59	Oregon	.21	0.29
Missouri	.25	0.35	Washington	.41	0.60
Nebraska	.22	0.41	Alaska	.70	0.59
North Dakota	.18	0.28	Hawaii	.10	0.12
South Dakota	.13	0.19			
Southeast					
Alabama	.67	0.85			
Arkansas	.56	0.78			

Source: ACIR staff computations based on U.S. General Accounting Office, "Including User Charges in the General Revenue Sharing Formulas Could Broaden the Measure of Revenue Effort," PAO-82-23, September 2, 1982, Table 12, pp. 50-51; and U.S. Department of Commerce, Bureau of the Census, **Governmental Finances in 1981-1982**.

been traditionally accepted, some have assumed that a massive switch from taxes to fees is underway. A working paper written for the Academy for State and Local Government discounts this assumption. Although revenues from user fees have increased, reliance on them as a source of finance has increased only for a few government functions.⁸ Rather, because spending for functions generally financed by fees has risen especially sharply, associated user charge revenue has also risen sharply. The examples cited in the study are utilities and airports, both of which are user-charge-financed activities that have experienced substantial spending increases since the early 1970s.

Earnings on 'idle cash' and other local revenue sources. State and local governments capitalized on the high interest rates of the 1970s and early 1980s to the point where interest earnings became a significant revenue source. Local governments earned \$13.7 billion in interest in 1982, up from just \$5 billion in 1977. Large and medium size cities and counties have become increasingly sophisticated in investing their "idle" cash and 18 states have established local government investment pools to help smaller localities make the most out of their short-term investments. Interest earnings have been one of the hottest growth items on the non-property tax side of the ledger but whether or not they will be able to maintain their startling growth rate will depend not just on local investment savvy but on prevailing interest rates generally.

⁸*ibid.*, p. 12.

Table 5
Local Selective Excise Tax Revenue Compound Average Annual Growth Rates by Type of Excise, by State, 1971-72 to 1981-82

State	Total	Motor Fuel	Alcohol Beverage	Tobacco Products	Public Utility	Other
Alabama	8.4%	4.6%	11.9%	5.6%	18.5%	24.2%
Alaska	16.5	N	—	—	(19.6)	N
Arizona	11.6	—	R	R	17.3	14.8
Arkansas	16.9	N	19.8	—	15.7	25.1
California	15.7	—	—	—	15.5	16.3
Colorado	13.8	N	N	(37.9)	15.3	29.5
Connecticut	—	—	—	—	—	—
Delaware	25.0	—	—	—	23.7	N
Florida	11.0	39.8	R	R	16.4	19.9
Georgia	16.5	—	12.6	—	19.5	22.3
Hawaii	11.8	7.5	—	—	21.0	—
Idaho	28.6	—	N	—	17.6	N
Illinois	18.3	N	N	87.8	13.4	29.0
Indiana	N	—	—	—	—	N
Iowa	18.8	—	—	—	12.5	N
Kansas	15.9	N	—	—	15.4	N
Kentucky	28.7	—	—	—	19.9	23.0
Louisiana	16.1	—	5.2	4.6	17.2	20.0
Maine	—	—	—	—	—	—
Maryland	18.4	—	4.8	—	7.9	19.3
Massachusetts	(25.5)	—	R	—	—	(22.6)
Michigan	11.1	—	—	—	18.9	N
Minnesota	9.3	—	—	—	11.1	1.9
Mississippi	16.6	7.5	R	—	19.1	N
Missouri	18.9	—	R	3.3	12.2	13.9
Montana	—	—	—	—	—	—
Nebraska	16.2	—	—	—	15.3	N
Nevada	13.6	7.8	—	—	17.2	16.1
New Hampshire	—	—	—	—	—	—
New Jersey	(17.8)	—	—	—	(49.7)	7.7
New Mexico	15.0	—	N	R	17.0	23.2
New York	8.2	(8.2)	N	2.1	12.3	7.4
North Carolina	71.4	N	N	—	R	—
North Dakota	18.7	—	—	—	17.7	N
Ohio	16.0	N	N	—	2.9	17.0
Oklahoma	17.8	—	N	—	16.8	38.8
Oregon	20.1	113.5	—	—	16.3	48.2
Pennsylvania	2.1	—	R	—	R	2.2
Rhode Island	R	—	—	—	R	—
South Carolina	64.8	—	—	—	65.2	R
South Dakota	N	N	—	—	N	N
Tennessee	12.0	N	10.5	(18.3)	10.7	21.8
Texas	19.7	—	34.2	N	18.2	27.8
Utah	23.0	—	—	—	22.4	29.2
Vermont	—	—	—	—	—	—
Virginia	9.3	N	—	4.1	8.0	24.2
Washington	15.5	—	—	—	14.0	17.1
West Virginia	16.2	—	9.9	—	17.3	57.9
Wisconsin	21.4	—	—	—	—	21.4
Wyoming	19.7	—	—	—	19.7	—
Median state*	16.1	7.5	11.2	2.8	16.0	21.8

N = new in period; R = repealed in period; — = not used either year.

* Medians were calculated using only those states in which the tax was used in both years.

Source: U.S. Bureau of the Census, 1972 *Census of Governments, Vol. 4, No. 5, Compendium of Government Finances* (Washington: Government Printing Office, 1974), Table 46; and data for 1981-82 provided in advance of publication by the U.S. Bureau of the Census.

Table 6
Composition of State Aid

(\$ in Billions)

	1957	1962	1967	1972	1977	1981	1982
Education	57% (\$4.2)	59% (\$6.5)	62% (\$11.9)	58% (\$21.2)	61% (\$37.0)	63% (\$57.2)	63% (\$60.7)
Public Welfare	15% (\$1.1)	16% (\$1.8)	15% (\$ 2.9)	19% (\$ 7.0)	14% (\$ 8.7)	12% (\$11.0)	12% (\$12.0)
General Aid	9% (\$0.7)	8% (\$0.8)	8% (\$ 1.6)	10% (\$ 3.8)	10% (\$ 6.4)	11% (\$ 9.6)	10% (\$10.0)
Highways	15% (\$1.1)	12% (\$1.3)	10% (\$ 1.9)	7% (\$ 2.6)	6% (\$ 3.6)	5% (\$ 4.7)	5% (\$ 5.0)
Other	5% (\$0.3)	4% (\$0.5)	5% (\$ 0.9)	6% (\$ 2.2)	9% (\$ 5.4)	10% (\$ 8.7)	9% (\$ 9.2)

Sources: *The States and Intergovernmental Aids* (1977), ACIR Report A-59, p. 10, *State Payments to Local Governments*, v. 6, No. 3, of the Census of Governments, U.S. Census, p. 14; *State Government Finances in 1981 and 1982*, U.S. Census, p. 10, adjusted for state intergovernment expenditure to federal government.

Also included in the "everything but property taxes category" are a number of other items. For example, revenues from selective excise taxes imposed by localities are growing as shown in Table 5. Local business income licenses and taxes also fall into this category. Revenues from local business income taxes vary widely—from over \$1 billion in New York City to less than \$500,000 in Flint, Michigan, according to a sampling of large cities that impose these taxes. Local business taxes perhaps more than any other single tax become enmeshed in the debate over taxes and business locational decisions. Although many argue that local taxes are but a minor component in this process, the fear of driving business away (coupled with state pre-emption of business income taxation and other factors) make hikes in this nonproperty tax unlikely.⁹

Intergovernmental Aid. Intergovernmental aid was an important force allowing localities to lessen their dependence on property taxes in recent decades. The result, however, was increasing dependence on federal and state grants. In 1962, for every dollar of taxes raised, local governments received 3 cents from Washington; in 1978, that figure had reached a high watermark of 18 cents for every local tax dollar.¹⁰ By 1982, showing the reversal of this trend, federal aid was only 13 cents for every dollar raised locally. State aid to localities also increased over the same 20 year period but the rise was neither as dramatic nor the fluctuations as great.

Most analysts do not foresee a quick return to the days of rapidly increasing federal aid. In fact, many believe that federal grants will do well just to keep pace with inflation and will continue to lag behind local revenue growth.

State aid, on the other hand, may fare better. One obvious reason is that the states themselves are enjoying better fiscal health and will presumably be in an improved position to assist their local governments. State intergovernmental aid, although more than keeping pace with inflation (see Table 6), has slackened somewhat as total state spending slowed down during

the past few years. By comparison to other revenue sources, however, state aid has been strong and growing, up by 7.4% to cities according to the JEC survey. Because so much state aid goes for education (over 60% of total state aid), renewed emphases on education reform and improvements may spur state aid in the future. After education assistance and public welfare, general "no strings" state aid to local governments ranks next in terms of state intergovernmental spending. This type of state assistance is a larger source of revenues to cities, counties and other localities than either local sales or income taxes (but not both combined). General state aid then should be given its due in any discussion of local revenue options and revenue diversification.

As a rule—with several big exceptions—states tend to emphasize either general aid or do-it-yourself local tax diversification, but not both. Rather than representing a conscious either/or choice, in practice, many general aid programs were created out of political realities rather than by public finance considerations. For example, revenue sharing in Michigan began as a package deal to gain acceptance of a state sales tax. Also, a substantial portion of states' general aid is earmarked to reimburse local governments for state-mandated property tax exemptions such as circuit breakers.

ENTREPRENEURSHIP

Another strategy for managing local finances is to cut expenses and/or expand the tax base. In some ways, local officials have always pursued these two alternatives, but in recent years their efforts have assumed new, entrepreneurial dimensions. No less than a redefinition of the role of local government is involved:

This new definition puts city government at the very heart of what happens to the community in all areas—from economic development to education, from cultural affairs to health issues—without the assumed responsibility for actually providing these services.¹¹

The new, entrepreneurial class of local leader also seeks to create a climate conducive to investment, hope-

⁹"Trends in the Fiscal Condition of Cities: 1981-1983," Joint Economic Committee, Washington, D.C., November 1983, p. 44.

¹⁰ACIR, *Significant Features of Fiscal Federalism*, 1982-83 Edition, Washington, D.C.

¹¹*The Entrepreneur in Local Government*, ed. by Barbara H. Moore, International City Management Association, Washington, D.C., 1983, p. 7.

fully providing employment and tax dollars.

Throughout American history, the role of the municipal corporation has dramatically changed. Before the Revolutionary War cities were primary actors in commerce and trade. By the end of the nineteenth century, theirs had become a minor role, subordinate to the private corporation and the state legislature. After the Second World War cities became responsible for land use planning and the delivery of an array of social services. Now the crisis of our cities requires a new role, one more directly related to the creation of primary wealth.¹²

Mayor Henry Cisneros of San Antonio, Texas has made creating a climate conducive to investment his number one priority. Baltimore has been called the "Cinderella City" because of its dramatic, if uneven, turnaround. New York City, where only six years ago the question was whether or not to formally declare bankruptcy, has tried and (by the Financial Control Board's assessment) succeeded in improving productivity with a shrunken work force and can now market bonds and notes on a regular basis.

In many respects fiscal realities gave birth to the new local entrepreneur. Like their counterparts in business, public entrepreneurs have often had to act to cut their losses. In municipal terms, because city governments are highly labor-intensive operations, payrolls had to be cut. All 25 cities in the 1983 *National Journal* survey had reduced, frozen or slowed the growth of their work forces. Chicago, for example, faced a \$150 million potential deficit and the new mayor cut nonpublic safety personnel by 15% during his first six months in office. Overall local government employment fell for the first time in modern history in 1981, down nearly 200,000 from its all time high of 9.4 million in 1980. Cities with longstanding financial problems began cutting back in the 1970s. Detroit, for example, has cut its workforce by 26% since 1978.

In *City Money*, the authors point out that a "city losing jobs and population can be fiscally sound if its public leaders trim expenditures in proportion to declining resources."¹³ In fact, they attribute city survival in the 1980s to an urban fiscal retrenchment that began much earlier—1974 to be exact. The fact that New York City did not begin pulling back earlier led to its financial crises, in contrast to a city such as Pittsburgh which tailored expenditures more closely to diminished resources. New York City's current fiscal health can be attributed both to retrenchment and to its highly diversified economy.

Changes in the ways services are delivered are harder to quantify than employment levels or even service levels. Nonetheless anecdotal evidence is mounting that rather dramatic changes are occurring in the ways public services are being delivered. For example, mu-

“ The most important ingredient in the local government survival mix may well turn out to be the decidedly entrepreneurial approach being taken by more and more local leaders. ”

nicipal departments are bidding against private contractors to provide city services. Or, city halls and county seats are co-providers with private suppliers. At the same time cities continue to transfer certain functions to other levels of government—such as Rochester, NY transferring police services to Monroe County—or they have entered into providing services in new areas.

CONCLUSION

Collectively, the many changes localities are undergoing amount to a bootstrap operation. Whether through searching for new revenues, cutting back services, changing service delivery, or spurring economic development, cities and counties weathered the financial crises, taxpayer revolts, and federal aid cuts of the 1970s and early 1980s. But not all local governments are out of the fiscal woods and many are still having a hard time recouping and regrouping following these three jolts and the recession. It is in helping localities still in need that the state's role may turn out to be critical. It is the state, after all, that can allow or disallow revenue diversification, provide equalizing aid among jurisdictions, and offer seed money for community investment. Outside assistance from whatever source, however, will be no substitute for local bootstraps. The most important ingredient in the local government survival mix may well turn out to be the decidedly entrepreneurial approach being taken by more and more local leaders.

Stephanie Becker is ACIR's Public Information Officer. This article is based on the Commission's Tax and Finance Section study, Local Revenue Diversification, being readied for publication.

¹²*Ibid.*, p. 61.

¹³Terry Clark and Lorna Ferguson. *City Money*, Columbia University Press, New York, 1983, p. 6.

Similarities and Differences: Federalism in West Germany and the United States

by S. Kenneth Howard

Startled, stimulated, reassured and resigned are all emotional reactions this author felt during two days of intensive roundtable discussions and many informal conversations that were held between small German and American delegations assembled to discuss the workings of their respective federalisms. This paper capsules the most striking similarities and differences that emerged during a bilateral symposium. These gleanings seemed to arise under three general headings: the effects of history and cultural values; the powers and roles of the states; and the impact of parties and the media. The first three sections that follow will take each of these categories in turn. Because these three sections tend to highlight differences, a fourth and final section will focus specifically on similarities.

THE EFFECTS OF HISTORY AND CULTURAL VALUES

The forms and practices of any government reflect the history from which they have emerged and the cultural values they are intended to promote. In the case of Germany, history is replete with constant warring among fiercely independent mini-states. All those lovely castles along the Rhine symbolize this independence, reflect the need for protection from one another, and highlight the relatively small physical territory dominated by any one sovereign. This German history predates by many hundreds of years and American experience with independent states. When each country faced the task of nation building, the challenges and approaches had to be different because each had to deal with its own unique historical forces.

Americans were trying to govern a territory which was much larger and more culturally diverse than that of their German counterparts. Indeed, Americans take pride in their diversity. We see it as a hallmark of our system and we encourage it. In establishing a nation, the American Founders had to recognize that separate sovereign and independent governments were already in existence and functioning. In fact, had those governments not been in place, it would probably have been impossible to organize a revolution, to win the resulting war and to govern after that war. When the members of the Constitutional Convention assembled, they did so as representatives of states, voting was done on a state-by-state basis, and ratification required individual state conventions. The Constitution is a creation of "We the People of the United States" but both the process of its creation and the document itself had to recognize the practical reality of existing states.

The German experience was quite different. Their cry in nation building was "Unity, unity, unity." To Americans, states are "complete" governments, not just parts of a total. Germans are much more willing to tolerate governments which are not nearly so self sufficient, asking only that these governments be integrated and coordinated into a whole that makes sense. In cliché terms, the Americans stressed dual federalism, the Germans cooperative federalism.

The Germans are deeply fearful that inequalities will foster disunity. Their demand for equality in a variety of public policy fields seems extreme to Americans to say the least. For example, college admissions in Germany are centralized nationally so that each applicant is assured of equal consideration for all the schools in the country and the available intellectual talent is spread more evenly across the schools. Student preferences and "market" processes are far less determinative than in the U.S.

Not surprisingly, the Germans have developed a very elaborate set of fiscal mechanisms for equalizing public services and tax burdens throughout their different governments.¹ There are fiscally richer and poorer

1. For further information on German intergovernmental fiscal relations, see **Studies in Comparative Federalism: West Germany** (M-128), Advisory Commission on Intergovernmental Relations, Washington, D.C., 1981.

German and American Federalism

Under the aegis of the Konrad Adenauer Foundation and the Council for International Urban Liaison and with financial support from the German Marshall Fund, delegations from the United States and the Republic of West Germany met in Buehlerhoehe, West Germany, last September to discuss the problems their respective nations face in making a federal system work. The American delegation included four past or present members of the U.S. Advisory Commission on Intergovernmental Relations (ACIR): Governor Scott Matheson of Utah, Mayor Tom Bradley of Los Angeles, Ambassador Richard S. Williamson, and Congressman Robert S. Walker of Pennsylvania. Other members of the delegation were former Minnesota Governor and U.S. Senator Wendell Anderson; Scott County (Iowa) Supervisor Maggie Tinsman who is also Chairperson of the Iowa ACIR; Lou Winnick of the Ford Foundation; and John Herbers of the *New York Times*. The German participants included Dr. Wolfgang Zeidler, President of the Federal Constitutional Court; Minister of State Friedrich Vogel; Chief Mayor Manfred Rommel of Stuttgart; Dr. Franz Rudolf Klein, President of the Federal Fiscal Court; Dr. Wilhelm Kewenig, a state senator from Berlin; Director Hans Ruhe of the Federal Ministry of Finance; Dr. Thomas Loffelholz, Editor in Chief of the *Stuttgarter Zeitung*; and Stuttgart City Manager, Dr. Wolfgang Schuster. The symposium was coordinated and directed by Professor Horst Zimmermann of Marburg University and Dr. S. Kenneth Howard, Executive Director of ACIR.

areas in Germany as in the U.S. In Germany, far more equalization occurs through the tax system and through revenue redistribution than through standardizing or centralizing services. However, the latter has occurred. For example, police protection is a state, not a local function, and teachers are paid by the states, not by localities or school districts.

Nonetheless, it is the tax sharing and redistribution system that provides most of the equalization effects. The tax sharing system is manipulated in such a way that unrestricted revenues are allocated to the poorer states over and above what they raise from their own resources using those same taxes. Those increments for the poorer states would otherwise have accrued to the richer states because of their stronger resource bases. This redistributive mechanism is available because certain specific taxes are constitutionally or legally shared between the state and national governments, and sometimes with local units as well. But how those receipts are divided among the various states is determined by formulas that recognize differences in fiscal capacity, special financial burdens, the degree of ur-

banization and population density, and national average tax capacity. As a general rule, no state has resources available for providing public services that are less than 92% or more than 110% of the national per capita average. Having some states directly send part of their tax revenues into a nationwide equalization fund for redistribution to poorer states cuts across the grain of American notions about state sovereignty, a concept the Germans easily let yield to the need for equity.

In fact the German Basic Law (Constitution) provides:

The Federation shall have the right to legislate in these matters to the extent that a need for regulation by federal legislation exists because the maintenance of legal or economic unity, especially the maintenance of uniformity of living conditions beyond the territory of any one (state), necessitates such regulation.²

In short, the German drive for unity is so concerned with equality in service levels and tax burdens that it makes virtually unconstitutional a federalism that stresses diversity!

Nor does the influence of this emphasis stop with legal and fiscal matters, it affects government structures as well. Discrepancies and differences can be mitigated by reducing the number of governments, thereby broadening the reach of the remaining ones. Generally, fiscal capacity differences between different governments within a common geographic area will be smaller in scale as there are fewer governments involved. The Germans have pursued just such a logic for promoting equality, having in recent years reduced the number of governments by two-thirds, from 24,000 to 8,000. There is little possibility anything comparable could be accomplished in the United States.

THE POWERS AND ROLES OF THE STATES

In many ways German states (Laender) hold powers American state officials would deeply envy. On the other hand, they lack strength in areas Americans deem fundamental to having effective power and to exercising it well. Interestingly, both countries are currently struggling internally with issues surrounding the role of the states in a federalism.

The most powerful tool in the hands of the Laender is the Bundesrat, a unique second house in a national bicameral legislature. The Bundesrat reviews all Bundestag (Parliament)-initiated laws which might affect state interests and can approve, alter, or veto such legislation. This power of review affects about 50% of all legislation passed and it is especially important in fiscal affairs.

Formally known as the Council of Constituent States, the members of the Bundesrat are appointed by the state governments and may be removed by them. In

Excerpts From "Notes On West Germany"

by Anthony Downs

POPULATION

The Federal Republic of Germany (West Germany) had a 1981 population of 61.4 million persons in an area of 96,000 square miles—about the size of Oregon or Wyoming (each of which contains fewer than 2.7 million people). So West Germany has 27.3% of the total population of the continental U.S. in 3.2% of its total area. West Germany's population was 50.2 million in 1950, rose to 61.8 million in 1974, and has declined since then. Its growth after 1945 included over 14 million refugees. That inflow was cut off by construction of the Berlin wall in 1961. East Germany's 1981 population was 16.8 million in an area about the size of Ohio, which had 10.8 million people in 1980.

West Germany is now experiencing a notable migration of households from north to south quite similar to our movement from the Northeast and Midwest to the South and West—though relatively smaller. It is occurring for similar reasons, too: the south has a more attractive climate and geography, many older persons are retiring there, the fastest-growth industries are located there, and the older, more obsolete heavy industries are in the north in the Ruhr area. Hence housing prices are higher in the southern states than in the north, and vacancies are rising in the industrialized Ruhr.

INCOME AND POVERTY

Why has Germany been more successful in almost eliminating poverty among its citizens than the U.S.? This was the most intriguing question raised by my visit, especially since the U.S. is perhaps a bit wealthier. My discussions with West German economists and others indicate that these West German traits lacking in the U.S. help explain this result:

- The West German government inherited a tradition of paternalistic care for the working class by the government that started with Bismarck. There was no such tradition in the U.S. until the New Deal of the 1930s, and even then it was not universally accepted as desirable or necessary.
- By the end of World War II, nearly all West German citizens, from the very richest to the very poorest, had personally experienced the hardships of extreme deprivation and loss,

both economic and personal. Everyone saw the desirability of creating a social welfare system that would help those injured by forces beyond their control to survive at a decent minimum standard of living.

- Until recently, the West German population consisted almost entirely of persons of German ethnicity who spoke German. This homogeneity prevented any large groups from being considered socially or otherwise inferior by the majority, and therefore discriminated against in any way. That has clearly not been the case in the U.S. We have a long history of ethnic discrimination, and many social aid programs predominantly serving blacks or other minority groups have been limited in resources for that reason.
- West German public education is far more equal in quality all across the country than U.S. public education. All schools are financed by the state and national governments, not local governments; hence they receive about the same funding per student regardless of where they are located. Also, teachers are civil servants who cannot refuse assignment to specific jobs; so the quality of teaching is much more even geographically. Finally, the vast majority of students come from ethnically-similar homes with parents highly respectful of the value of education.

This drastic reduction of poverty through operation of a welfare state has some costs, too, though it is hard to prove exactly how large they are. Tax receipts as a fraction of gross domestic product in 1980 were lower in the U.S. than in West Germany but higher in France and Sweden than in West Germany. Fringe benefits now comprise about 70% of total wage costs per worker, and it is difficult to fire workers once they have been hired. Firms are reluctant to hire additional workers, preferring instead to substitute capital for labor. Moreover, small businesses have more difficulty getting started than in the U.S. All these factors may be related to the much slower growth of employment in West Germany than in the U.S., and the supposedly larger extent there of the so-called "underground economy" that does not pay taxes. There is now pressure to shift to a 35-hour week to spread the work around. But doing so without reducing worker incomes would increase labor costs and thus reduce the competitiveness of West German products in world markets.

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fact, the states' governors decide who will represent each state in the Bundesrat and for how long. In practice, the effective working membership of the Bundesrat consists primarily of career bureaucrats, most of whom come from the ministries of the formally-designated members. Voting is weighted slightly to recognize population size differences among the states, but each state casts its votes as a block.

The Bundesrat is not simply a second house; it exists separately from the Parliament. There may have been some similarities between the Bundesrat and the U.S. Senate before the popular election of Senators was ratified in 1913, but there is certainly little today.

Furthermore, the law requires that the associations of state and local governments be consulted as policies and statutes affecting these governments are being developed. The American system contains no comparable legal assurance of broad-scale participation by representatives of state and local governments.

Finally, the national government is prohibited from dealing directly with local governments. There are no national-local grants, for example. Everything must go through the states. Anything the national government does for or with local governments is completely at the sufferance of the states. There simply are no such "things" as federal-local intergovernmental relationships.

Envy among American state officials decreases sharply when they understand that German states have no independent taxing authority. Most state revenue comes from taxes which by national law are distributed in set proportions among the three levels of government or are divided between the states and the national government. The actual rates and coverages of these shared taxes and of those taxes assigned exclusively to the states are determined by the national government. To the extent that these tax sources are economically sensitive (most are), the states must ride with the economic tide, having virtually no taxing authority of their own with which to offset economic vicissitudes. The equalization advantages of the German tax-sharing system have come at the expense of state fiscal autonomy.

The Bundesrat also cuts two ways. It clearly gives a stronger hand to the states' governors, but it does little to enhance state legislatures. Indeed, German state legislatures are far less powerful than their American counterparts, especially in the fiscal field. Much of what the Laender parliaments adopt must conform with national "framework" laws and there are relatively few areas without such national legislation. German leaders recognize this weakness and are trying to find appropriate ways to enhance the role of state legislatures.

Given their lack of power in other fields, and their very powerful role vis-a-vis their local governments, it is not surprising that the German state legislatures spend a lot of time regulating local government activities, much to the consternation of German local officials. Indeed, one felt very much at home listening to mayors talk about their relations with their state governments, no matter which language was being spoken.

“ The German penchant for regulation and legalization gives sustenance to the state legislatures. ”

The German penchant for regulation and legalization gives sustenance to the state legislatures. They regulate local governments so closely that even zoning changes and many kinds of budget actions require state approval. Furthermore, there is no such thing as an independent local school board on the German local government scene. If the states are in many ways administrative arms of the national government, the local governments are lackeys of the German states.

The American system may have nothing really comparable to the Bundesrat, but some means are available for reviewing the geographic or territorial impacts of proposed legislation and policies. For example, many states and several large cities try to protect and promote their legislative and program interests by maintaining offices in Washington, D.C. These offices obviously test every major proposal by asking: What does this do for us in (name of jurisdiction)? In addition, a variety of regional organizations have been created to look out for "western," "southern" or other such interests. There are even regional groupings among the members of Congress with staffs and other capabilities for appraising proposals in terms of their specific geographic implications. Nonetheless, these mechanisms pale in comparison with the Bundesrat for assuring that specific state interests and concerns are reflected in national policy deliberations and programs.

Discussions about the roles of the states also generated many "sounds-just-like-home" feelings! Clearcut distinctions or dichotomies in roles between national and state governments will probably never work in highly volatile political settings. Ambitious politicians rarely want to acknowledge that an issue is outside their purview; if they can't appear to be in control they at least want to appear informed, concerned and striving to improve things. Practical politics tend to obliterate finely honed separations—a dynamic balancing act is always in process.

The German Basic Law recognizes this reality more forthrightly than the American Constitution. Both documents itemize functions which are exclusively national, such as defense and issuing currency. The U.S. Constitution uses a "residual powers" approach for everything else, while the German Basic Law distributes the remaining functions in a much more defined way. Certain functions are listed as "concurrent"—where state action is possible as long as federal action has not been taken. Other functions are listed as cooperative—both can operate in these fields with the extent of "cooperation" to evolve through the political process. The Basic Law even specifies how the costs of supporting these latter joint tasks will be al-

located between the national and state governments. Somewhat surprisingly, two specific issues are causing stresses in both nations' efforts to make federalism work: acid rain and distributing the proceeds from severance taxes. The difficulties encountered in reconciling national and state interests in both of these areas are comparable on both sides of the Atlantic.

Clearly power in each country has tended over the years to become more and more centralized. Given their stronger imperial history, Germans may be more prone than Americans to accept such hierarchical tendencies, but neither nation has been unaffected by the various social forces (war, recession, modern technology and broad social movements) that encourage centralization of governmental power. Nonetheless, Americans would probably never tolerate having their states become administrative arms of the national government to the extent that such a condition exists in Germany today.

PARTIES AND THE MEDIA

Governments are controlled and shaped by politics. Politics in turn are heavily affected by parties and the media. It is in these areas that the sharpest contrasts emerge in the ways that the Germans and the Americans make their federal structures work. As for parties, there are important national differences in their legal standing, their ability to discipline members, and in the way campaigns are financed. The media contrasts are equally vivid.

Unlike American parties, German political parties are specifically mentioned in the constitution. Indeed, German parties are recognized as organizations of government and governance; in terms of standing and privilege they are on a legal par with other constitutional entities. As might be expected, there is a great deal more national legislation concerning parties and elections in Germany than in the United States. In the U.S., virtually all of this field is governed by individual state legislation.

Beyond their legal role, the German parties play another vital role in policy development. Most major public policy issues are thrashed out and debated through party circles and processes before they emerge in the formal public consultative and legislative arenas. The parties, for example, offer a route mayors can and do use to get attention directed to local concerns that are common nationwide. German parties are not just election-campaign phenomena as parties tend to be in the United States; they are an established and respected mechanism for raising, analyzing and resolving major substantive policy issues. Some observers would even contend that having the parties in this role is what enables the formal governmental systems, including federalism, to work.

By European standards, there is no discipline in American parties. Indeed, American politicians can often get more attention and media coverage by bolting a party or by actually campaigning against it than by any other action. In a political system where name recognition is a major key to success, parties can be useful

whipping boys as well as helpful symbols.

As in most European parliamentary systems, a German party is far stronger and far more politically significant than its American counterpart. Part of its strength and discipline stems from ideological considerations, but this force should not be overstated. German parties' ideological positions are much clearer than those of American parties, but wide shadings of opinion exist within German parties as well. Furthermore, the Germans are beginning to see non-partisan "parties" and organizations increase at the local level and national single-issue groups are also emerging. It is not clear what impact these new tendencies may have on the basic party structure which has dominated Germany since the end of World War II.

The most significant instruments for promoting German party discipline are far less subtle than ideological compatibility: inclusion on the ballot and campaign financial assistance. The American system is dominated by single-member-district and winner-take-all practices which place tremendous emphasis on the individual candidate. Furthermore, the American penchant for primary elections means that an individual can obtain a party's label and ballot position without having any or much support within the party's organization and leadership. Primaries obviously weaken party discipline and they are virtually unknown in Germany. Primaries make campaigns more costly and give strength to interest groups and single-issue organizations that have money and human resources to offer a campaign. Such groups are not unknown in Germany, but they are far less powerful than in the United States.

To get on a German ballot, a candidate needs the endorsement of the party. Few candidates run as individuals for specific seats. Most of the seats in the national and state legislatures are allocated proportionally according to the vote each party garners throughout the jurisdiction doing the electing. The individuals who get these non-candidate-specific seats come off party "lists." The nearer one stands to the top of the list, the more likely one is to win a seat. The party must win more and more votes for candidates placed lower and lower on the lists to win one of the proportionally assigned seats. Assuming a reasonably competitive jurisdiction, persons listed early are relatively assured of election. These are the "safe" seats in German politics. One's placement on the "list," however, is up to the party, an obvious inducement to party fealty.

The party is also the key to campaign financing. For the most part campaigns are publicly financed in Germany. Although individual contributions are sought and given, they are not the backbone of campaign financing and the sophisticated direct mail solicitation that has become commonplace in the United States is simply not done in Germany. The public funds are put at the disposal of the party for it to use as it sees fit. Individual candidates, especially ones disloyal to the party, have a hard time attracting campaign funds under these conditions.

Media costs now constitute the largest expenditure in

most major American political campaigns. In the United States, the free market operates among both the print and the electronic media. In Germany, the electronic media, both radio and television, are publicly owned and operated. The print media is not so constrained.

Under legislation supported by both parties, the national government allocates radio and television time to the parties in accordance with the proportion of votes each received in the last relevant election. The parties in turn determine how that time will be used. Individual candidates simply cannot "buy" time. This arrangement enhances party discipline further and reduces the tendency for successful candidacy to be a function of one's ability to raise money by whatever means. These arrangements also tend to minimize the advantages of running a negative campaign against an individual opponent.

To assure some objectivity in news coverage, individual reporters are given a lot of independence in the German electronic media, with the expectation that they will use this independence in a professionally responsible manner. Such reporters also enjoy much greater job tenure than their American equivalents. German parties understand well that whoever is in control today may be out of power tomorrow. Fears seem almost non-existent in Germany that the government will abuse its control of the electronic media for campaign purposes and self-promotion.

TENDENCIES AND SIMILARITIES

Despite the sharp differences in their political party practices and their media settings, the German and American systems seem to be moving down some similar paths, some of which may be more paralleling than converging, but at least they are not diverging.

In both nations, present interest in governmental decentralization may reflect current economic conditions more than changes in underlying political values. Both nations are coming out of deep economic recessions. When fiscal resources are scarce, all sorts of ideas get reconsidered, including greater governmental decentralization. However, the basic social forces which encouraged more and more centralization in the first place have not really abated. It remains to be seen whether the decentralization movement in either country can sustain itself after economic recovery.

Rebalancing either federalism probably means moving more resources and powers toward local governments. The extent to which such shifts take place in either country depends primarily upon the actions of state governments. How the states choose to treat their local governments on a variety of matters will keenly affect how much decentralization actually occurs. Within the state governments, the state legislatures seem most important, particularly in the extent to which they want to continue heavy-handed regulation of local governments, especially in Germany. How the state legislatures respond to the leadership of their respective governors and to the concerns of their local

governments is an unsettled but challenging issue in both nations.

Both countries are reconsidering how they distribute the various governmental functions among the different governments. In the United States, this process has come to be known as "sorting out." It was given a sharp forward thrust by President Reagan's New Federalism proposals. The German concern is more subdued at this time, but serious questions are being raised about the joint state-federal functions and whether or not they should be rearranged in significant ways. Some changes may be accomplished statutorily, but others would require constitutional amendments. The complexity and political difficulty of this undertaking are recognized in

NOTES . . .

URBAN PLANNING, AFFAIRS, AND POLICIES

- A rather authoritarian planning tradition in West Germany influences the layout and operation of urban areas, as well as many other aspects of life. For example, housing construction quality standards are even higher and costlier than in the U.S. Retail stores are not open evenings or on Sundays because of opposition from unions and owners. Television programming is heavily influenced by governments. There are two national channels and one regional one, and they operate for many fewer hours than in the U.S.
- In West German urban areas, central-city boundaries have been extended out to encompass most surrounding built-up areas. State legislatures did this in the past decade without major opposition from the suburbs. This extension permits more coordinated control of land-use developments in fringe areas, and helps reduce the relative fiscal burdens of central-city governments.
- Because central cities influence land-use regulation of surrounding areas, they have slowed development of outlying shopping centers. This plus their excellent public transit systems have kept downtown retail districts the main centers for retail shopping in each metropolitan area. Most big cities have extensive pedestrian malls in the hearts of their downtowns, under which run urban subway systems. Outside downtowns, there are serious parking shortages, and cars are jammed onto parkways and along curbs everywhere.

—Anthony Downs

“ The American concern with altering current fiscal interrelationships seems driven by necessity; the German interest seems more motivated by ideological considerations. Nonetheless, the issue is common to both and changes seem in the offing. ”

both countries but in both the matter is on the public agenda even though changes in either nation will probably be slow in coming.

Both nations are also looking at the extent and nature of their intergovernmental fiscal arrangements, but from very different motivations. Germans are wondering whether their large-scale tax-sharing system unduly reduces political accountability at the state and local levels. They increasingly appreciate the adage that those who enjoy the pleasure of spending should also suffer the pain of levying taxes to support that spending. Where state and local governments raise relatively little own-source revenue, pittances by American standards, one would expect the issue of political accountability to be far more telling, but the more serious debate on this issue is currently taking place in the United States, not Germany.

Present American concern about fiscal interdependencies is a direct outgrowth of large federal deficits and the recent recession. The national government is trying to reduce its deficits and raising additional revenues will probably be one major component of that effort. States have seen the recession simply wipe out their accumulated surpluses and they have been forced into enacting more and more tax increases just to sustain services at levels approximating their current ones. In the taxation field, there is little new under the sun. Both levels of government might tap the same sources of revenue in ways that would prove mutually undesirable. Finding additional national revenues by closing certain so-called “tax expenditures,” such as the federal income tax exemption given to interest earned on state and local bonds, will set off sharp conflicts within the American federal system.

The American concern with altering current fiscal interrelationships seems driven by necessity; the German interest seems more motivated by ideological considerations. Nonetheless, the issue is common to both and changes seem in the offing.

Both nations are experiencing mounting legalization of their intergovernmental processes. The German drive for legal perfection far exceeds American faith in perfecting government and society through statutory and legal means. Americans complain about the extent of government regulation, but the Germans leave them far behind when it comes to amplifying framework

legislation through regulations. German governments at all levels seem far more legally constrained than American ones in their ability to take action. The plethora of laws and regulations surrounding German governments appears to be far more constraining and action inhibiting than that surrounding governments in the United States.

Finally, German tolerance and desire for diversity and for greater state and local autonomy appear to be growing. Germans are becoming increasingly aware of the many costs that accompany their insistence on nearly absolute equality as the price of unity. In this respect, they would like to move further along the path followed by the United States.

CONCLUSION

Differences in the way federalism is practiced in the United States and Germany probably demonstrate that each nation is doing what it should: governing in a manner true to its unique history and cultural values. There are obvious differences in the extent to which each nation believes that equity and fairness require equality. But “equity,” “fairness” and “equality” are just words or concepts subject to diverse definitions and practical applications. Are they to be provided in terms of geographic areas, living standards, opportunities, income levels, some of these, or none? Value judgments and shadings of the highest political order are required in dealing with such issues. Thus politics, appropriately, will continue to shape how either federalism evolves and the differences that emerge may be a healthy indication that politics are alive and well in both nations.

S. Kenneth Howard is ACIR's Executive Director.

MEASURING TAX BURDEN

by Michael W. Lawson

A Fiscal Note

“... in this world nothing is certain but death and taxes.”—Benjamin Franklin

Little has changed since Benjamin Franklin coined this popular American aphorism. In fact, if Franklin were alive today, even he might be surprised how well this phrase has retained its poignancy over the last two centuries!

The ACIR staff recently calculated the amount of taxes that typical families in each state would pay in direct taxes. The taxes included in this study were federal income and Social Security taxes, state and local income taxes, state and local general sales taxes and the local tax on residential property. Some of the major findings in the study were:

(1) **A typical family earning \$25,000 paid 22.0% of its income in major direct federal, state and local taxes in 1982.** For the family earning approximately twice the median family income (\$50,000), direct taxes represent 28.5% of family income.

(2) **Without question, taxes imposed by the national government represent the major portion of the family tax burden.** The average federal tax bite (income and Social Security taxes) was approximately three times that of the average state-local tax bite in 1982. For the family earning \$25,000, taxes imposed by the national government took 16.6% of family income while state-local taxes garnered 5.5% of family income. For families earning \$50,000, the figures were 23.2% and 5.3%, respectively.

(3) **The actual amount of state-local taxes paid varies considerably among the states.** Families earning \$25,000 and residing in Detroit, Milwaukee and Philadelphia paid over 9% of their income in state and local taxes. Families with identical income residing in Anchorage, Casper, Jacksonville, Las Vegas and New Orleans, however, paid less than 3% of their income in state-local taxes.

(4) **The importance of the deductibility of state-local taxes on the federal income tax return increases greatly as income rises.** For example, the family earning \$100,000 living in New York was shown to pay \$5,529 less in federal income taxes than the family with the same income living in Anchorage. Why? Because the New York family was able to claim a much larger deduction for state-local taxes paid than the family living in low-tax Anchorage. Furthermore, income is taxed at higher (marginal) tax rates at higher income levels so these deductions become progressively more valuable to taxpayers as their incomes rise.

(5) **The much-cited measure “per capita tax collections” often is an inadequate measure of tax burden.** For example, the states of Alaska and Wyoming have the highest per capita state-local tax burden in the U.S. (\$6,422 and \$2,384, respectively—the U.S. median in 1982 was \$1,096). Yet, in terms of state-local direct tax burden on families, Alaska and Wyoming are at the bottom of the list—they rank 50 and 51, respectively. Why is this so? Although neither of these states has an individual income tax (and Alaska does not have a state general sales tax), both states are able to raise a great deal of their tax revenue from severance taxes on oil and natural gas. Some portion of these taxes is then exported to non-residents in the form of higher fuel costs to consumers and lower corporate dividends to non-resident stockholders.

Several caveats must be kept in mind regarding these figures. First, the figures printed in Table 1 are for families residing in the largest city in each state. In many instances, the figures are a reasonable estimate of the state-local tax liability of a family residing in almost any city in the state. In other cases—particularly in Detroit, Philadelphia, New York and Louisville—the taxes in these cities would be considerably more than what residents in other parts of the state would pay.

Second, it should be noted that some states, particularly those in the southeastern and southwestern parts of the country, rely more heavily upon user charges to finance public services. Hence, although taxes are a very large and important components of what government exacts from the citizenry, they do not constitute the entire monetary burden that is imposed by government.

Last, and most importantly, the family tax burden study makes no attempt to address the expenditure side of governmental operations. Ultimately, citizens must decide whether benefits derived from services provided by the public sector are worth the cost of those services. Although the study recognizes this vitally important issue, it does not (nor could not) attempt to measure how well that balance is achieved.

[Single copies of **Tax Burdens for Families Residing in the Largest City in Each State, 1982** are available by writing ACIR, 1111 20th St. N.W., Washington, D.C. 20575.]

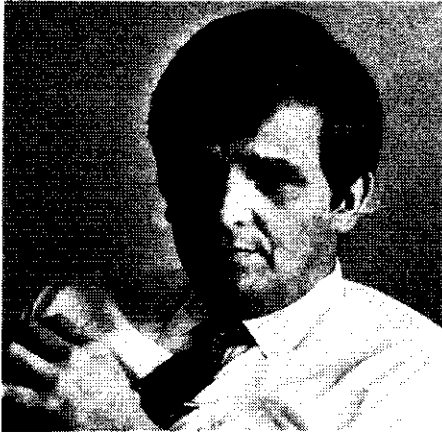
Michael W. Lawson is an analyst in ACIR's Taxation and Public Finance Section.

Table 1

A Comparison of Direct Tax Burdens for a Married Couple with Two Dependents, Located in the Largest City in Each State, for Selected Federal and State-Local Taxes, 1982
As a Percentage of Income

City and State by Region	Income Level: \$25,000			Income Level: \$50,000		
	Total for Selected Taxes	Total Federal Taxes*	Total State-Local Taxes	Total for Selected Taxes	Total Federal Taxes*	Total State-Local Taxes
U.S. Median	22.01%	16.56%	5.45%	28.46%	23.21%	5.25%
New England						
Bridgeport, CT	22.32	16.47	5.86	27.62	23.71	3.91
Portland, ME	22.75	16.34	6.41	29.72	22.35	7.38
Boston, MA	24.28	15.90	8.38	29.73	22.43	7.30
Manchester, NH	21.33	16.73	4.60	26.96	24.14	2.82
Providence, RI	23.43	16.12	7.31	29.71	22.35	7.36
Burlington, VT	22.96	16.29	6.66	29.46	22.46	6.96
Mideast						
Wilmington, DE	21.77	16.60	5.17	29.36	22.62	6.74
Dist. of Columbia	23.72	16.03	7.70	30.29	22.00	8.49
Baltimore, MD	23.96	15.98	7.97	30.04	22.19	7.85
Newark, NJ	22.76	16.34	6.42	28.19	23.40	4.78
New York, NY	24.46	15.85	8.61	31.46	21.30	10.17
Philadelphia, PA	25.10	15.68	9.42	30.47	21.88	8.59
Great Lakes						
Chicago, IL	22.86	16.29	6.56	28.45	23.25	5.20
Indianapolis, IN	21.56	16.64	4.92	27.89	23.60	4.30
Detroit, MI	26.17	15.37	10.80	31.30	21.41	9.88
Cleveland, OH	23.06	16.25	6.81	29.27	22.70	6.57
Milwaukee, WI	25.41	15.59	9.82	30.97	21.61	9.36
Plains						
Des Moines, IA	23.58	16.07	7.50	29.61	22.50	7.11
Wichita, KS	20.96	16.82	4.14	27.99	23.48	4.51
Minneapolis, MN	22.78	16.34	6.44	31.00	21.61	9.39
St. Louis, MO	21.56	16.64	4.91	28.27	23.32	4.94
Omaha, NE	22.18	16.47	5.72	28.83	22.97	5.86
Fargo, ND	20.47	16.95	3.52	27.25	23.93	3.32
Sioux Falls, SD	21.86	16.60	5.26	27.49	23.79	3.70
Southeast						
Birmingham, AL	21.91	16.56	5.35	28.33	23.32	5.01
Little Rock, AR	21.38	16.73	4.65	28.68	23.09	5.59
Jacksonville, FL	19.71	17.17	2.54	26.48	24.45	2.02
Atlanta, GA	22.02	16.56	5.46	29.13	22.78	6.35
Louisville, KY	23.07	16.25	6.82	29.43	22.58	6.85
New Orleans, LA	19.58	17.22	2.37	26.94	24.18	2.75
Jackson, MS	20.40	17.00	3.40	27.65	23.75	3.90
Charlotte, NC	22.14	16.51	5.63	29.30	22.70	6.60
Columbia, SC	21.24	16.78	4.46	28.90	22.93	5.97
Memphis, TN	21.12	16.78	4.35	27.41	23.87	3.54
Norfolk, VA	22.34	16.47	5.87	28.92	22.93	5.98
Charleston, WV	21.06	16.82	4.24	28.15	23.40	4.75
Southwest						
Phoenix, AZ	21.44	16.69	4.75	28.46	23.21	5.25
Albuquerque, NM	20.41	16.95	3.46	27.58	23.75	3.83
Oklahoma City, OK	20.41	17.00	3.41	28.16	23.40	4.75
Houston, TX	21.26	16.73	4.53	27.52	23.79	3.73
Rocky Mountain						
Denver, CO	21.30	16.73	4.57	28.08	23.44	4.64
Boise, ID	22.81	16.34	6.48	29.56	22.50	7.05
Billings, MT	21.33	16.73	4.60	28.22	23.36	4.86
Salt Lake City, UT	23.12	16.20	6.92	29.30	22.62	6.68
Casper, WY	19.50	17.26	2.24	26.19	24.61	1.58
Far West						
Los Angeles, CA	22.01	16.56	5.45	29.24	22.74	6.50
Las Vegas, NV	19.57	17.22	2.35	26.22	24.61	1.61
Portland, OR	24.44	15.85	8.58	30.56	21.84	8.72
Seattle, WA	20.96	16.82	4.14	27.04	24.10	2.93
Anchorage, AK	19.54	17.26	2.28	26.09	24.69	1.40
Honolulu, HI	24.03	15.98	8.04	30.39	21.96	8.43

*The reason that federal tax liabilities are not the same for all states is because state and local taxes have been deducted from taxable income in the federal income tax calculations. Taxes included are federal income and Social Security taxes, state-local income and general sales taxes and the local property tax.



The Chairman's View

Dear Reader:

A revolution in the provision of public goods and services is taking place throughout the United States. Governments contracting with private organizations, cooperative agreements among jurisdictions and provision of municipal services by neighborhood groups are all variations on a single theme: New ways of producing public goods and services are here to stay.

A decade ago conventional wisdom held that the best way to provide public services was through existing public agencies. The last ten years, however, have seen cutbacks in public funding (encouraging an intensified search for efficiency) as well as a growing body of successful experience with innovative means of providing government services.

Working under government contract, nonprofit community groups in a number of cities have begun to provide municipal services. In Kansas City neighborhood groups perform building code inspections. In Portland, Oregon a neighborhood group has won a contract from the county to run an alcohol detoxification clinic.

Governments have long contracted with profitmaking firms but the range of functions performed has been broadened, well beyond construction work and trash collection. For instance, RCA operates the state-owned prison in Weaversville, Pennsylvania. The Corrections Corporation of America owns and operates incarceration facilities for the U.S. Immigration and Naturalization Service. Localities in California have hired private operators for hospitals and mass transit systems while Control Data Corporation provides publicly-financed vocational training in Minnesota. The State of Utah has recently authorized the contract provision of virtually all public services.

A government can contract for pri-

ivate service delivery and simultaneously provide the same service itself. Oldbridge Township, New Jersey has established the policy of dual provision for garbage removal—half of the township is served by private contractors and the other half by the public works department. In this way, the two suppliers compete with each other, keeping a check on costs. If either supplier became more costly the township could easily switch to the other. Dual provision provides benchmarks for comparing the cost, responsiveness, and quality of the services delivered which enhances governmental and citizen monitoring.

Cooperative agreements among governments for service provision are quite common. Three cities in Jefferson County, Texas jointly operate a firefighter training facility, a police dispatching service and a sanitary landfill. In addition to this example of cooperation within the same level of government, governments at different levels also cooperate. State forestry departments have long provided fire protection to rural communities.

Public officials are increasingly aware of yet another aspect of cooperation: the fact that cooperative citizen actions can greatly improve both the efficiency and effectiveness of public programs. Public services should not be "produced" and "supplied" as if passive consumers were being provided toasters. For example, parents have an important role to play in their children's education and most of them recognize this. Encouraged by government, neighborhood street watchers help police patrol operations. Citizen cleanup efforts greatly assist the work of municipal street cleaners. Recognizing this "co-production" of public services is the first step in expanding the collaboration between service providers and citizens who are truly citizens, and not merely passive clients of local governments.

The recognition that certain public services are also available privately leads to the idea of vouchers, another innovative delivery form. Publicly subsidized food stamps, a form of

voucher, allow the recipient to go and shop almost anywhere, making it possible for individuals to choose what they judge to be the best food at the best price. A new national program offers 5,000 housing vouchers to low income persons in 18 locations. The vouchers supplement what the renter can afford to pay for housing (without skimping on other necessities), filling the gap between what is affordable without the voucher and what safe and adequate housing costs in that community. Rather than being limited to publicly built or rehabilitated housing, voucher recipients can shop for the housing they most prefer, anywhere within their community.

Two fundamental ideas thread their way through this wide range of examples. First, governmental delivery is not necessary for every service that the voters choose to finance publicly. How a public service is delivered is a different question from how that service is to be financed. When that idea is recognized some officials and citizens will choose to move from traditional forms of service delivery to contracting out. Freed from being involved in operations they cannot perform well, governments can better fulfill their fundamental responsibilities of governance.

The other fundamental idea is that, especially with the wide range of options now available, there are explicit choices to be made in selecting delivery mechanisms for public services. No one means of delivery works best in all cases. Because the idea is to widen the range of choice for means of delivery there may be no advantage in replacing a public "monopoly" with a private monopoly. The entire spectrum of options for providing services should be considered.

Behind these ideas and their practical applications lies current research to improve the provision of public services. In a recent seminar with the ACIR staff, Ted Kolderie of the Hubert H. Humphrey Institute of Public Affairs at the University of Minnesota described his research and implementation work in the Twin Cities area. Among other efforts, he

ACIR Adopts Intergovernmental Tax Policy, Takes Stand on Municipal Antitrust Liability

At its March 2 and 3 meeting, held in Phoenix, Arizona, the Commission asked that Congress not increase federal selective excise taxes or enact a new national consumption tax. Excise and sales taxes are simply too important to state and local governments, the Commission said, and a major national move into these taxes would restrict state and local abilities to finance whatever levels of public service they desire.

The federal revenue picture could be improved by building on the reforms incorporated in the *Tax Equity and Responsibility Act of 1982*, which terminated the most serious abuses of private-purpose tax-exempt financing. The Commission recommended against placing any new federal volume caps on these bonds but instead advocated

- eliminating tax-exempt financing for projects that do not merit federal assistance or that do not contribute to economic development;
- eliminating certain instances of "double dipping" in which businesses benefit from another tax benefit in addition to tax-exempt financing; and
- limiting the total amount of small issue IDBs allowed any one user.

The Commission specifically proposed that its suggested restrictions not apply to multi-family housing bonds, economic development bonds for distressed communities and single-family housing bonds (although the Commission did support retaining volume caps on the latter if Congress extends mortgage subsidy bond tax exemptions).

In addition, the Commission reaffirmed its longstanding support for indexing federal income taxes.

The Commission also took up the municipal antitrust issue at its March meeting. A series of Supreme Court decisions have substantially exposed cities, counties, towns and their officials to federal antitrust law. These decisions have spawned considerable uncertainty at the state and local levels as to how states can best

provide immunity to their localities, as allowed under current Court decisions. Because of this uncertainty, the Commission urged Congress to amend federal antitrust laws to establish broad guidelines for how states may extend the present "state actions exemption" to their localities when these governments are acting under the authority of state laws and within their governmental capacities.

A second part of ACIR's policy recommends that the immunity be provided rapidly and in accordance with a number of substantive principles, including: the scope of any immunity not be based on a distinction between governmental and proprietary activities; local governments should be protected for any activities they undertake for which their respective states would be immune; any shield should apply equally to general and special purpose governments; the Supreme Court's requirement that allegedly anticompetitive activities be actively supervised be satisfied by local supervision; the purpose of governments and their officials is different than that of private firms and people—that is, to service the public interest—so the rules used for judging the former under federal antitrust laws should consider the benefits to the public of the actions in question; and, where public bodies and officials are found in violation of these laws, they should be subject not to treble damages but to injunction of their anticompetitive activities.

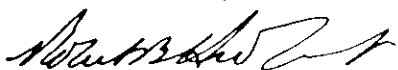
Senior Analyst Beam Leaves Commission

David R. Beam, a senior research analyst with the ACIR, left in April to join The Naisbitt Group. Dr. Beam first became a member of the Commission's Government Structure and Functions staff in 1974 when he was selected as a research fellow. He became project manager of ACIR's major research, **The Federal Role in the Federal System**, and, more recently, directed the Commission's in-depth review of regulatory federalism. The Naisbitt Group specializes in analyzing political, social and economic trends.

has developed bidding procedures allowing individual neighborhoods to choose their own form of trash collection. In addition, the ACIR is currently completing an update of its work on intergovernmental public service arrangements such as inter-local contracts, joint service agreements and the transfer of functions from one level of government to another. The new study will highlight trends in local service provision.

At the forefront of the study of alternative means of delivering public services is Indiana University's Workshop in Political Theory and Policy Analysis. A wide range of studies there, supported by the National Science Foundation, have examined specific public services and evaluated their provision by a variety of public and private organizations. Operations in a sample of metropolitan police departments were recently studied. Compared to large cities in the same metropolitan areas the smaller municipalities provided police protection better tailored to the communities served, at less cost, more effectively and with a higher level of citizen satisfaction. The most surprising finding was that large scale provision of police services through municipal consolidation is unlikely to be cost effective.

The key principle is public management through choice. Officials now have many tools in their toolkits. They must choose among public, private, and jointly public-private means now available for delivering public services. Even simply discussing alternatives can stimulate improvements in traditional delivery practices. In making their choices, government officials should be prepared to assess the options' costs and benefits, both quantitative and qualitative. Blessed by a rich array of possibilities for service delivery, we can now begin to use new and better ways to perform government operations and to conduct the public's business.



Robert B. Hawkins, Jr. Chairman

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