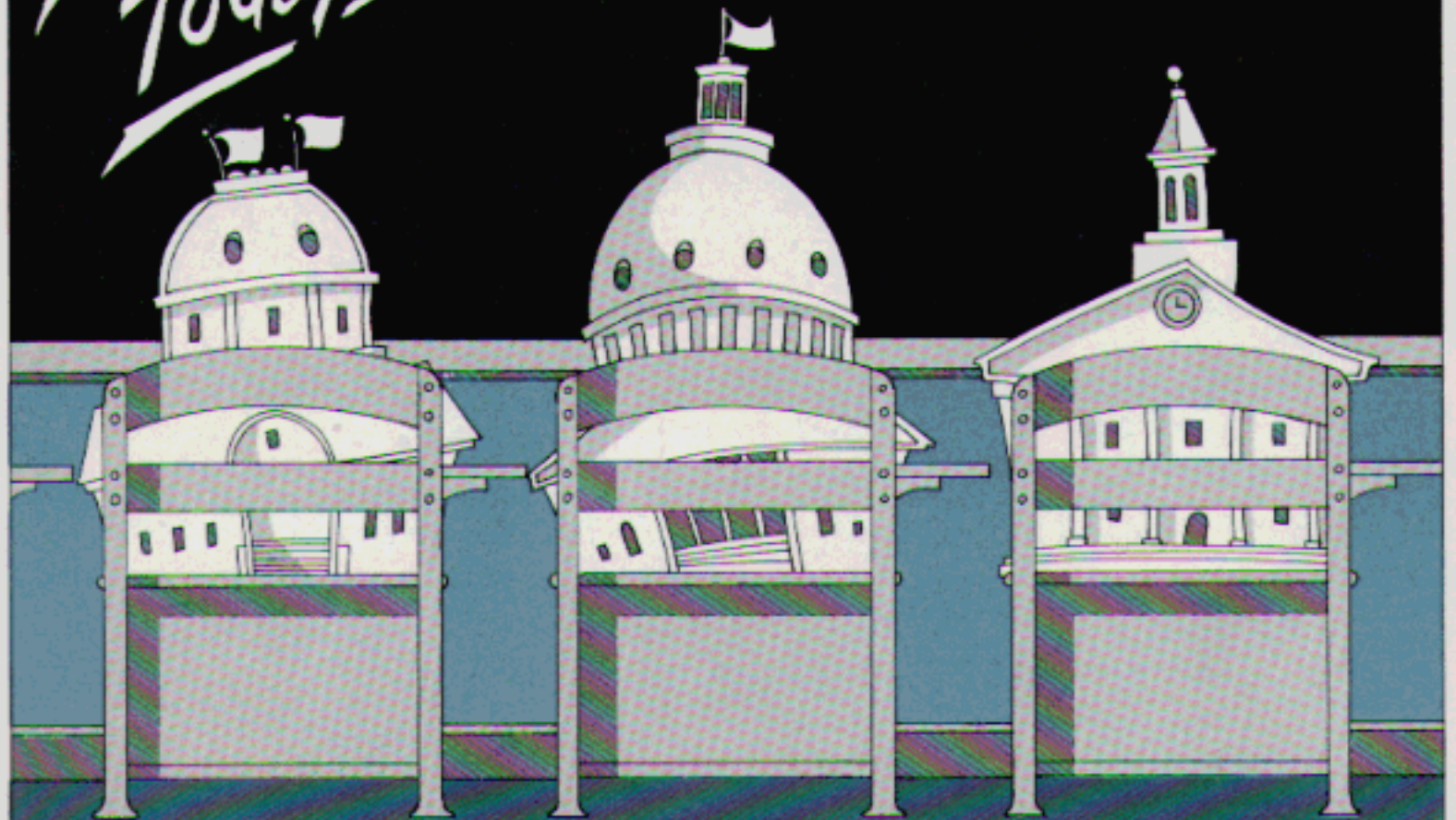


Intergovernmental

# PERSPECTIVE

*Exam  
Today*

- 1. Taxes*
- 2. Home rule*
- 3. Federal aid*



**For the States,  
A Time of Testing**

# View From The Commission



Dear Reader:

This is an exciting period of change in the American federal system and for ACIR. This is my first report as Chairman of ACIR and one of the first publications being produced by our new Executive Director, S. Kenneth Howard. It is also a period in which we have many new Commission members. Under these conditions, we will maintain continuity by guaranteeing the high quality of work expected from ACIR and change by looking at old problems from fresh perspectives. One role will not change: ACIR will continue to stimulate national attention and debate on issues of federalism. Only through a national dialogue will real reform occur and last.

Before turning our attention to the articles in this issue, it is important that we take a minute to remind ourselves of the roles that states have and can play in the federal system.

The founding fathers never intended states to be mere administrative arms of the general government. Far from it. States, historically, Constitutionally and politically have been full partners to the federal bargain; they were political and governmental entities in the fullest sense of the word. Through legislative policy

making, states for years have responded to problems by creating and implementing policy for a broad range of domestic concerns.

Two state roles are of particular interest as we enter a period of federalism reform. The first is the broad state power and authority to set the rules by which local governments are created, operate and can be changed. While most local officials are willing to admit that we need new urban policies, they are fearful of having *federal monies passing through* states. What is missed in this fear is the opportunity. If national urban policies and grants have not solved the "urban crisis," we must try a new urban policy in which states play a key role. The federal government cannot by itself establish an urban policy. Ultimately, it is a state-local responsibility, a responsibility of citizens and their elected officials close to home. Hopefully, as a stronger state role vis-a-vis communities emerges, we will see a truly federal urban policy based on real partnership.

An important offshoot of a federal urban policy is to be found in the lexicon of community issues. Neighborhoods and community schools are merely two issues that have great citizen support. Yet, advocates of these issues seldom focus their efforts in state capitols but look to Washington. While sometimes justified, what cannot be overlooked is the critical role of states authority in addressing these important issues.

If federalism reform is to have any lasting effect, we must also address the second important state function. Until recently, states have been the centers of electoral policies and the constituent members of our national parties. By setting the rules for election to office, controlling reapportionment and as the mainstays of state political parties, states have played an important role in the poli-

tics of federalism and in guaranteeing diversity and pluralism in American society.

As the centers of politics, states are important influences on Senators and Congressmen. Politics provided an integrating force where state needs could be communicated effectively to elected representatives. Thus, we should give serious consideration to the argument that with the weakening of state party systems, the politics of federalism has also been weakened, creating, in part, the present imbalance in the federal system.

While no one wants a return to boss rule, it is also clear that we must reopen the question of a politics of federalism, for it may be through a politics of federalism that we can create the institutional framework to sustain reform in the federal system.

The articles in this issue focus on several of the critical issues facing states, local governments and citizens. Each in its own way, raises fundamental questions of federalism. How do states react to federal and local pressures? How do states set their urban policies? And, how do states set the rules for the provisions of services? Each of these issues raises one of the critical questions of federalism: How do we assess the capabilities and limitations of alternative policy options? Our role is to provide elected officials, administrators and citizens with the kind of information that assist them in answering this question.

A handwritten signature in black ink, appearing to read "Robert B. Hawkins". The signature is fluid and cursive, written in a professional style.

Robert B. Hawkins  
Chairman

# PERSPECTIVE

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# Intergovernmental FOCUS

## New Federalism Proposals Still Tentative, State and Local Groups React

President Reagan's proposals for New Federalism, originally put forward in his State of the Union Address last January, have been the subject of negotiations between the White House and state and local officials for several months. The President's initiative has changed considerably over this period and, in late June, the Administration released a set of "Tentative Administration Decisions" on its federalism proposal, the broad outlines of which were confirmed by the President in his July 13 speech before the National Association of Counties.

Unlike the original proposal (described in detail in the Spring 1982 issue of *Intergovernmental Perspective*), the Administration no longer insisted upon an end to the national food stamps program. Instead, the "swap" of functional responsibilities among levels of government would affect only Medicaid and Aid to Families with Dependent Children (AFDC). The revised plan still called upon the states to take over AFDC. The federal government, as its part of the "swap," would take over a portion of Medicaid. The federal government would fully finance a basic core of acute care medical services for the poor, with the "poor" defined as those currently eligible for Supplemental Social Security and baseline state AFDC programs. In addition, the federal government would provide a "block grant" to the state for long-term health care. The states would be responsible for all additional long-term care costs above federal block grants and costs for other categories for the poor.

The "Tentative Administration Decisions" paper also included changes in the "turnback" and trust fund components of the original plan. The number of federal programs to be turned back to state and local governments was shortened. Programs dropped from the "turnback" list include black lung, migrant health, Women and Infant Children, Primary Highway Transportation, Urban Development Action Grants, and Occu-

*pational Health and Safety Act* state grants.

The Administration also deleted references to the oil windfall profits tax as part of the Trust Fund created to finance the New Federalism "swap." Instead, part of the financing for the interim trust fund would be derived from federal general revenues, thus leading some to believe that a scaled down trust fund could be retained for an indefinite future. The tentative proposal called upon the Advisory Commission on Intergovernmental Relations to study the general revenue portion of the trust fund (\$8.8 billion from general revenues was proposed).

Finally, some changes were made in the way federal monies would be funneled to local governments through the states. The 15% uniform mandatory passthrough of federal monies to local governments under former federal-state programs was dropped. A 100% passthrough of federal funds would be required of states, however, for programs, like the Community Development Block Grants to large cities, that are now administered totally at the local level.

## State And Local Officials React

Interest groups representing state and local officials have all held that income security should be the primary responsibility of the national government. In addition to questioning whether states and local governments should fully assume AFDC costs, these public interest groups have expressed a number of concerns about the revised New Federalism initiatives.

On behalf of the National Governors' Association, Governor Richard Snelling (VT), then the Association's chairman and a member of NGA's six-person team that negotiated with the White House on the New Federalism proposals, said on July 16: "We have made substantial progress in negotiating a federalism proposal that would deserve the support of the states, local governments, and the Congress, but, if the plan is to be fair and workable, remaining questions on welfare and Medicaid responsibilities in particular must be favorably re-

solved." Specifically, four areas are as yet unresolved, Governor Snelling stated. These include:

- 1) eligibility in federally funded Medicaid programs for those who become medically needy when high family health costs drain their financial resources;
- 2) decoupling food stamps and AFDC requirements. The current linkage between the two programs discourages states from raising basic welfare payments at the risk of losing federal food stamp payments;
- 3) a "safety net" for states suffering economic or fiscal hardship; and
- 4) encouraging realistic and just levels of state assistance to the poor.

In August, at the annual NGA meeting, the Governors agreed to continue their negotiations with the President while developing their own federalism reform proposal.

The National Conference of State Legislatures, at its annual meeting in July, echoed many of the Governors' Association's concerns. NCSL policy stressed that continued deliberations on the proposals be sensitive to the fiscal conditions of the states, and be developed to minimize disruption of services to the poor, elderly and handicapped.

The National League of Cities, at its board meeting in July, turned thumbs down on the revised Administration proposal. Although the League commended the President's federalism objectives, it could not support the plan as modified. "In general," said the League's president Ferd Harrison, mayor of Scotland Neck, NC, "the proposal tilts much too strongly toward the states and leaves cities with virtually no security while turning over all major city grant-in-aid programs to state control." The states, in the League's view, "should remove constitutional and statutory barriers that keep cities from raising sufficient revenues to meet their needs."

The National Association of Counties' July meeting did not result



in any changes in its federalism policy. NACo's policy essentially supports the direction of New Federalism, but calls for provisions to assure local funding levels and local participation in state funding and taxing decisions.

Because important differences still remain between state and local officials and Administration over the shape of the New Federalism, little action is expected this year. White House spokesman have said that no federalism legislation will be sent to Congress until 1983.

### **Three More State-Local Advisory Commissions Created**

The enactment of nine block grant programs last year, and the continuing debate about new federalism initiatives and "sorting out" functions between government levels, have turned the intergovernmental spotlight increasingly toward state capitals. One consequence has been renewed interest in state ACIRs and similar intergovernmental advisory organizations.

Over the past several months, at least three more states—Iowa, Washington and Georgia—have created new commissions. Currently, about half the states have an ACIR or similar organizations to discuss state-local issues and to make recommendations for change.

In Iowa, a 21-member ACIR was established by statute to study and report on allocating state and local financial resources, the powers and functions of local government, and special problems involving interstate areas. Seventeen of the members are appointed by the governor—four each representing the state, cities, counties and school boards and one member representing regional councils. Four legislative members (two from each house) are appointed by their respective leadership.

Creation of the new panel was a high legislative priority of Governor Robert Ray as well as the local government associations. The new ACIR is expected to serve as a vehicle for formal communications among state and local officials. Staff support will be provided by the Governor's Office

for Planning and Programming. Appointments have been made, and the ACIR commenced operations in late summer.

In May, Governor John Spellman signed an executive order creating the Washington State ACIR. The 21-member panel will draw its membership from cities, counties, the legislature and state agencies, and will be chaired by the Governor. The new panel has been charged with examining the relationships between state and local governments. Its first order of business will be to review the variety of new federalism initiatives and to assess their likely effects upon the state.

The Georgia Commission on State Growth Policy was established by statute this year and will begin operation in January 1983. The 15-member panel will serve as a forum to discuss intergovernmental problems, growth and development, service delivery, and urban-rural relationships. The Commission has also been directed to examine tax equity issues and to report on them to the governor and the legislature by the end of next year. The members will include three senators and three representatives appointed by the leadership of their respective chambers and nine members named by the governor, including two elected city officials.

### **New Intergovernmental Consultation Order Issued; A-95 Rescinded**

On July 14, President Reagan signed Executive Order 12372 that revokes the Office of Management and Budget (OMB) Circular A-95 and replaces it with a broader intergovernmental consultation and federal program review process. The new order seeks to give state and local officials an opportunity to create their own review and coordination procedures; to encourage more timely and effective participation by state and local elected officials in decisions regarding federal projects and programs in their jurisdictions; and to reduce federal regulations.

Under the new order, federal agencies will be required to "make every

effort to accommodate the recommendations of state and local governments" regarding federal programs and activities affecting those jurisdictions. Specifically, federal agencies must inform state and local officials of their proposed actions as early as possible; defer to the states' own consultative and review procedures concerning federal actions; and, where state and local recommendations cannot be "accommodated," explain why in a "timely fashion."

The order is intended to strengthen the authority of state and local elected officials by shifting the initiative to them for setting their own review procedures and for determining federal program priorities in their areas. Under the A-95 process, state and local officials had to follow federally prescribed procedures in reviewing programs. This process was established to facilitate interagency coordination at the federal level and to help coordinate federal programs on a regional or areawide basis. It required that interested and affected parties be notified before the federal government could fund a project in a given area. Regional planning organizations were established and received federal support to perform this function.

OMB Circular A-95 will remain in effect until final regulations are issued on April 30, 1983. During the interim, OMB will undertake two activities. First, it will develop draft agency regulations to be published after the first of next year, including a listing of all existing federal statutory and administrative consultation requirements. Second, it will monitor state and local efforts to develop their own consultation and review processes.

The new order does not apply to: proposed federal legislation, regulations and budget formulation; direct payments to individuals; programs where federal agencies have no funding discretion or direct approval authority such as General Revenue Sharing and block grants; or classified activities involving national security. Federally recognized Indian tribes also are exempted from the order.

## Administration Reports Progress On Regulatory Relief

State and local governments have saved between \$4 and \$6 billion in total investment costs, \$2 billion in annually recurring costs and almost 11.8 million work hours per year thus far as a result of the Administration's regulatory relief efforts, according to an August 4 report released by the Presidential Task Force on Regulatory Relief.

The report, entitled *Reagan Administration Achievements in Regulatory Relief for State and Local Government*, states: "By eliminating those provisions in federal regulations which go beyond proper bounds of federal concern, the administration is making it easier for state and local governments to fashion their own solutions and set their own priorities. In addition, the Administration's relief efforts are returning regulatory responsibility to those units of government which are most accountable to the people affected by regulations."

The Task Force, chaired by Vice President Bush, had identified 111 federal regulatory programs for extensive review. Nearly one-quarter, 27, related directly to state or local activities. About half of the 27 have already been changed, the recently released report states, including withdrawal of bilingual education rules; elimination of the cost accounting requirement in the school lunch program; consolidation of health and human service programs into seven block grants; changes in the Davis-Bacon prevailing wage rules (currently under court challenge); and deletion of Section 504 requirements by the Department of Transportation.

In addition, the task force announced eight new regulatory relief initiatives affecting state and local governments. They are the Department of Education's general administrative regulations; the Health and Human Services Departmental grant administration manual; mass transit labor protection provisions; charter bus operation regulations; airport layout plan approvals; protection of historic and cultural properties; EPA state implementation plans; and, floodplain management.

## Two New Intergovernmental Groups Being Formed

The Committee for Intergovernmental Tax Equity, a non-profit organization, was recently organized by local officials concerned with advancing the concept of payments in lieu of taxes (PILOT) on tax-exempt property. Their specific target is to get Congress to enact a comprehensive PILOT program for federal real property. According to research conducted by the ACIR, the federal government now owns over 775 million acres of land and 23,998 installations with 2.5 billion square feet of floor area, having a total 1978 estimated value of about \$279 billion. In 1980, the ACIR recommended that Congress authorize a tax equivalency system for federal payments in lieu of taxes on federal real property. Programs currently authorized to compensate states and localities for the tax loss on federal property do not approach what the localities lose in property taxes, estimated by ACIR at \$3.65 billion a year.

In 1980, the Commission also advocated creating a state-local legal defense group "to monitor and institute legal action opposing 'coercive' conditions attached to federal grants and 'intrusive' Congressional exercise of the commerce power." Such an organization is now in the formative stages.

Seven public interest groups representing state and local officials have pledged funds to the State and Local Legal Center contingent upon matching grants from private foundations. The Center released in July a *Symposium, State and Local Government Issues Before the Supreme Court*, and is planning a second issue. The *Symposium* was prepared as an example of the kind of analyses the Center plans to conduct.

# For The States, A Time Of Testing

For the fourth time this century, the states are being called to judgment. During the Great Depression, when economic conditions overwhelmed the states, many shared the view that "The American state is finished." Again, in the 1950s, critics condemned them as malapportioned "horse and buggy" governments and were dismayed by the continuance of state-sanctioned segregation in the South and discrimination throughout the country. In the 1960s, they were yet again chastised for their insensitivity to urban needs: federal grants programs were fashioned to go directly to localities, bypassing the states. By the beginning of the 1980s, states were being put to the test once more.

Today, states are being challenged by: the New Federalism proposals for major federal system restructuring; deteriorating economic conditions; federal aid reductions; Congressional appropriations delays; regulatory shifts; and, legal challenges. Further, they face pressures from within: hardpressed local governments look to them for assistance and a growing number of special interests seek their aid. Some who witness the states' predicament continue to express doubts about their abilities to meet these challenges. They recall that in the 1930s, the 50s, and even the 60s, much of the criticism directed at states was deserved.

But the states of today face their current tests from a stronger and far different position than in earlier decades. After a quarter-century of unparalleled reform, they can boast that, in general, their constitutions have been modernized, their court systems streamlined, and their legislatures reapportioned, reorganized and professionally staffed. The governors' authority as chief executives has been strengthened, their office staffs upgraded, and their control over administrative agencies extended. On the financial front, revenue systems are now diversified and more equitable. Aid to localities has increased substantially, and state governments currently assume the major burden of local education costs and state-local welfare expenditures.<sup>1</sup> Most states weathered the 1974-75 recession fairly well, carrying sizable surpluses in some instances into the "taxpayers' revolt" of the late 1970s.

This article will examine the major fiscal, regulatory and judicial "tests" facing the better-armed states today and provide perspective on how they are faring in the context of President Reagan's New Federalism. Ultimately, the issues of state performance and capabilities raised by New Federalism pose a deeper question, what do we as a people expect of our states? Before we judge them, this article concludes, let's look at their traditional and current roles in the federal system and evaluate what we think states should do.

## **Fiscal Pressures: Beyond Any One State's Control**

### **Fiscal Stress**

National recession, beyond the reach of any single state's control, places extraordinary pressures on those states hardest hit. The economic recession threw revenue estimates off while rising unemployment rates spelled higher welfare burdens and compensation costs. A fiscal survey of the states released by the National Conference of State Legislatures in July 1982, reports, "a majority of states are beset by the worst fiscal conditions in 40 years. . . . Next year, may, however, be worse."<sup>2</sup>

The difficulties states face are by no means uniform;

<sup>1</sup> ACIR, *State and Local Roles in the Federal System*, A-88, Washington, DC, U.S. Government Printing Office, 1982, Chapter 3.

<sup>2</sup> Steven D. Gold, Karen M. Benker and George E. Peterson, *State Budget Actions in 1982*, July 1982, Summary.

# “Federal aid cutbacks have been made even more painful by budgetary procedures that obstruct state financial planning.”

a lucky few, “flush” in receipts from severance taxes on oil, coal and gas, appear to be weathering the economic downturn pretty well, even lowering taxes in some instances. Most states, however, have had to increase taxes, cut services, postpone expenditures, use accounting gimmicks, and take other measures to make up for revenues lost through declining sales and income taxes, the two principal sources of state revenues (see “A Fiscal Note” on page 30 of this *Perspective* for a list of state tax actions).

State revenue systems, diversified to grow with the economy, have also become more vulnerable to downswings. Further, during the last major recession, federal aid to states and localities was on the increase. Today, recent cutbacks in federal grants add to an already bleak fiscal picture at the state level. Although federal aid actually peaked in 1978 when adjusted for inflation (that is, in constant 1972 dollars), its decline in unadjusted, current dollars first occurred in fiscal year 1982.

The downward trend in federal aid is expected to persist. The effect of the cuts depends largely upon where they fall.<sup>3</sup> The National Governors’ Association’s budget analysis for FY 1983 states: “As was the case with the FY 1982 cuts, it is likely that a substantial percentage of these cuts will be ‘passed through’ state and local governments, so that the ultimate effects will fall upon service recipients.”<sup>4</sup> Another immediate short-term effect will be to slow the pace of capital expenditures; eventually, however, pressures will build on states and localities to undertake needed construction, the NGA report predicts.

## Federal “Clouds Of Uncertainty”

Federal aid cutbacks have been made even more painful by budgetary procedures that obstruct state financial planning. Delays in the Congressional appropriations process, even before federal aid began to decline, caused budgetary problems for states. Governor Richard Snelling (VT), in testimony before Congress last year, asked that the “clouds of uncertainty that overhang the federal system”—especially the appropriations process—be dispelled.<sup>5</sup> Little progress appears to have been made on this front. Just this summer Congressional appropriations battles caused delay over funds for secondary wastewater treatment plants.

Other national financial actions also produce “clouds

of uncertainty” limiting the ability of the states to maneuver themselves into more comfortable fiscal positions. The recent difficulties some states faced with unemployment compensation benefits are illustrative. The high rate of unemployment placed a heavy drain on unemployment compensation funds and some states have had to borrow from the national treasury to meet these obligations. About a dozen, however, faced a potential sudden and unexpected cutoff in federal funds for extended benefits. In Maryland, for example, the governor had to call a special session of the legislature to deal with an early federal cut off of supplemental benefits for those without work for longer than 26 weeks, the period for which unemployment compensation is normally paid. The elimination of the 13 weeks of supplemental benefits had been expected on September 26 and, in its regular 1982 session, the Maryland General Assembly had provided for the state to replace the expired benefits. Because of a change in the formula for federal contributions that eliminated from the calculations some of those out of work for more than 26 weeks, however, Maryland, Illinois, North Carolina and several other states found that supplemental benefits would be terminated earlier.<sup>6</sup>

The 1981 changes in the federal tax laws added to these problems by reducing tax yields in some states. For the many states that tie their corporate depreciation schedules to the federal provisions, recent alterations are eroding their revenues. Similarly, federal provisions expanding eligibility for, and limits on Individual Retirement Accounts, reinvested dividend exemptions, the authorization of all-savers certificates, and accelerated depreciation on rental property all are cutting state tax revenues. The case of Michigan is illustrative. Governor Milliken outlined the state’s plight in his 1983 budget message. The state, he said, will lose \$5 million due to the all-savers certificates interest exemptions; \$10 million due to increased tax exemption contributions to individual retirement accounts and other pension provisions; and, \$20 million from accelerated depreciation in the new capital cost recovery system and other business provisions.

**The Tax Equity and Fiscal Responsibility Act of 1982**, passed by Congress on August 18, will alleviate some of the fiscal anxieties the states face. The 1982 legislation repeals further accelerations in depreciation allowances, scheduled to go into effect in 1985 for most business capital investments. Those states conforming to federal depreciation rules will consequently experience a smaller reduction in state corporate tax receipts than they otherwise would have. The recently passed bill also made major changes to the unemployment compensation program. An additional six to ten weeks of unemployment benefits were made available to be financed out of federal general revenues and not the unemployment trust fund.

Other effects on state finances of the recently enacted tax package are less certain. The doubling of federal

<sup>3</sup> **The Proposed FY 1983 Federal Budget: Impact on the States**, National Governors’ Association and National Conference of State Legislatures, February 1982.

<sup>4</sup> *Ibid.*, p. 23.

<sup>5</sup> As quoted in the National Governors’ Association, **Governors’ Bulletin** No. 82-36, June 25, 1982, p. 2.

<sup>6</sup> Alison Muscatine and Margaret Shapiro, “Hughes Calls Special Session on Legislature,” **Washington Post**, July 28, 1982, p. A22.



## Budget Balancing In The States

Developing a budget for the 1982-83 fiscal year proved very difficult in most states this year. Surveys of state fiscal conditions are all revealing recession's effects on state revenues and the emerging picture is bleak. All of the 50 states have strong traditional, constitutional or statutory requirements that their budgets be balanced and most strive to end their fiscal years with balances equal to about 5% of expenditures. According to the *Fiscal Survey of the States 1981-82*, released by the National Governors' Association and the National Association of State Budget Officers, aggregate year-end balances for FY 1982 are estimated at 1.5% of total state expenditures, a considerable decline from 4.5% the preceding year.

Year-end balance figures reflect only a state's operating expenditures. Unlike the federal budget, most state budgets are, in reality, two separate budgets: general operating funds and capital project funds. Although the states are not generally allowed to run deficits, they do have accumulated debts associated with past capital projects that are not reflected directly in state operating budgets.

In FY 1982, many states dealt with revenue shortfalls by budget cutting, increasing selected taxes, postponing capital projects, or freezing or reducing employment levels. They also drew down more than

\$4 billion in state operating balances. Obviously, if balances are down to \$2.4 billion at the end of FY 1981-82, as the NGA/NASBO survey estimates, states will not be able to repeat last year's performance.

Although all states are required by law—or, in the case of Vermont, by tradition—to maintain balanced budgets, seven states ended their 1981-82 fiscal years with deficits. According to a survey conducted by the National Conference of State Legislatures and the Urban Institute, *State Budget Actions in 1982*, these seven states were Connecticut, Minnesota, New Hampshire, Ohio, Oregon, Washington and West Virginia. The seven were able to have a deficit either because their balanced budget requirements apply only at the end of each biennium rather than each fiscal year, or deficits are permitted if unforeseen events occur.

The NCSL/Urban Institute survey lays the blame for state fiscal woes on the recession's doorstep, not on federal aid cutbacks. The drop in federal aid did not dominate budget deliberations because "Most states did not replace much of the federal funding which was lost for their programs," the survey reports, (but) "If President Reagan's proposals for fiscal year 1983 are adopted by Congress, the budget problems caused by decreasing federal aid will grow."

excise taxes on cigarettes could hinder state initiatives to raise this tax, a popular source of state funds in recent years. Further, although major threats to the market for tax-exempt bonds were averted, some limitations were imposed that could increase state and local interest costs.<sup>7</sup>

### Pressure From "Within"

Local governments, equally pinched by inflation, unemployment and reduced federal aid and with more limited revenue resources, look to the states to help them meet their obligations. States with tax and spending lids may find this support hard to give. California for example, is having to reduce aid to localities because the state's surplus with which it initially moderated the impact of Proposition 13 has been depleted. Moreover, it must operate under state spending and tax limitations (see article on page 22 of this *Perspective*).

### The Pitfalls Of Regulatory Reform

Regulatory shifts present yet another set of challenges and uncertainties for the states. In recent years, state (as well as local) officials have voiced increasingly sharp protests against federal requirements which, from their perspective, are unnecessarily rigid, costly or, in

some cases, even invade the sphere of Constitutionally protected state authority. The Reagan Administration promised substantial regulatory relief for state and local governments, as well as for the private sector, and early in 1981 formed a task force, headed by Vice President Bush, to identify major problems and propose specific remedies.

A measure of progress has already been made. A recent task force report indicated that 24 rules affecting state and local governments have been revised, with estimated savings of between \$4 and \$6 billion in total investment costs and \$2 billion in annually recurring costs.<sup>8</sup> Additional requirements are presently under review. (see the "Intergovernmental Focus" section of this *Perspective* on page 5 for a further description of the Task Force's report).

Still, overall experience to date suggests that it is somewhat easier to reduce federal aid flows than to cut federal requirements. There are numerous possible pitfalls. Revised rules must pass through the same lengthy, complex process that newly proposed requirements do, so opportunities for delays abound. The regulators themselves may be reluctant to undo their handiwork of years past, and those who benefit from existing standards of procedures may be counted on to

<sup>7</sup> **Update on Congressional Spending Decisions.** National Conference of State Legislatures and National Governors' Association, August 26, 1982, p. 2.

<sup>8</sup> **Presidential Task Force on Regulatory Relief. Reagan Administration Achievements in Regulatory Relief for State and Local Government: A Progress Report.** August 1982.

“Finally, although relief is surely a mixed blessing, it is (like many other blessings) sometimes mixed.”

raise objections. The federal courts are a further complicating factor. Judges, not bureaucrats, often make the final interpretation of legislative intent. For example, administrative revisions to the **Davis-Bacon Act** prevailing wage requirements are now under legal challenge.

Furthermore, meaningful regulatory relief in many instances may require the assent of Congress. So far, little progress has been made in redrafting such complex statutes as the **Clean Air Act**, presently up for legislative extension. A dozen major cities have been threatened with the possible loss of hundreds of millions of dollars in federal aid, as well as a ban on the construction of new factories and businesses, for failure to attain the air quality standards established by existing law. Also, although the Senate earlier this year passed a landmark regulatory reform act that contains a number of provisions benefiting state and local governments, the outlook for parallel action by the House is still uncertain.

From the state standpoint, then, one key question is whether or not the promised regulatory relief will provide adequate recompense for the sharp cuts in assistance, both past and prospective. At the same time, critics question whether the states possess the will and the resources to carry out complex and often unpopular regulatory responsibilities.

Finally, although relief is surely a blessing, it is (like many other blessings) sometimes mixed. The point is illustrated by the saga of the nine new block grants, enacted by Congress in 1981, that were intended to give states greater flexibility in using lessened federal financial resources. Federal administrative requirements have been held to a bare-bones minimum. But some state and local officials have expressed concern that available guidance is inadequate, and fear second-guessing by the courts or federal agencies at some later date. Similarly, a shift of national regulatory policy toward providing greater discretion at the state level will expose state officials to more intensive political pressures commensurate with their expanded responsibilities.

### The Courts: A Continual Trial For States

Federal courts have, more often than not, given the “green light” to federal intervention in state and local affairs.<sup>9</sup> As the recent Davis-Bacon situation implies, even when the federal government tries to withdraw from an area or make changes, the ultimate decision often falls to the courts. Thus, although the regulatory reform efforts by the Administration may be a welcome

sign of relief to state and local officials, they know the courts frequently have the last word.

Federal courts, although they always have had a powerful impact on the states, have increased their influence in recent years, as a result of increased state activities generally and the growing tendency of citizens to resort to litigation.

Civil rights statutes, in particular, have given rise to a virtual “litigation explosion,” probably beyond the wildest dreams of their original sponsors. One constitutional law casebook reported that 56,922 private cases (not involving the federal government or its officers) raising a federal question were filed in the U.S. District Courts in 1976. Of these, a total of 17,543 were against state and local officials for civil rights violations.<sup>10</sup> Section 1983 of the **Civil Rights Act of 1871**, in particular, has been employed as a basis for suits.

In what has been described as a “smorgasbord guaranteed to give lawyers whatever point they are arguing,”<sup>11</sup> recent Supreme Court opinions involving state obligations to aliens seem designed to cause state confusion. Holding in **Cabell v. Chavez-Salido**<sup>12</sup> that California’s exclusion of *legal* aliens from jobs as probation officers did not violate the Fourteenth Amendment’s provision that no state “shall deny to any person within its jurisdiction the equal protection of the law,” the Court said, “Aliens by definition are those outside the community.” Yet, in **Plyer v. Doe** and **Texas v. Certaint Underdocumented Alien Children**,<sup>13</sup> the court required Texas to educate illegal alien children. Justice Brennan explained, “We cannot ignore the significant social costs borne by our nation when select groups are denied the means to absorb the values and skills upon which our social order rests.”

The Supreme Court’s decisions on the question of state and local immunity from suit by private citizens under the Eleventh Amendment have also induced uneasiness. Two observers of the Court commented on what had happened in these suits:

During the early 1970s, . . . state and local governments tended to assume that the perceived “conservatism” of the Court would assure balanced results. This attitude has now been shaken by a dramatic series of cases construing the **Civil Rights Act of 1871**. . . . In 1978, the Court eliminated local government’s immunity from damages under section 1983, an immunity it had conferred in 1961. . . . Two years later, the court ruled that local governments do not have a “good faith” defense to section 1983, thus exposing them to liability

<sup>10</sup> P. Bator, P. Mishkin, D. Shapiro and H. Weschler, **The Federal Courts and the Federal System**, 2nd ed., Supp. 1977, as cited in A. E. Dick Howard, “States and the Supreme Court,” **Symposium: State and Local Government Issues before the Supreme Court**, reprinted from **Catholic University Law Review**, Vol. 31, Spring 1982, p. 379.

<sup>11</sup> Fred Barbash, “Court’s Rulings Hinged on Middle Faction,” **Washington Post**, July 4, 1982, p. A8.

<sup>12</sup> 50 LW 4095 (1982).

<sup>13</sup> 50 LW 4650 (1982).

<sup>9</sup> ACIR, **The Federal Role in the Federal System, in Brief**, Washington, DC, December 1980, p. 15.

for violating rights *that were not judicially recognized* at the time the violation occurred. . . . Shortly thereafter, the court further held that section 1983 provides an enforcement vehicle, not just for civil rights, but *for all federal statutes*.<sup>14</sup>

The extension of Section 1983 to violations of all federal laws in **Maine v. Thiboutot**<sup>15</sup> caused special consternation in the states. Justice Powell summed up the practical effects of the decision in his dissent. ". . . state and local governments, officers and employees now may face liability whenever a person believes he has been injured by the administration of any federal-state cooperative program, whether or not that program is related to equal or civil rights."<sup>16</sup> Subsequently, the Court narrowed the application of this case somewhat by holding that if a federal statute expressly sets out a

remedy, the additional remedies provided under this section are precluded.<sup>17</sup> According to legal authorities, however, the consequences of this case for states and localities remain ambiguous and, in some instances, could generate a "Catch 22" situation where local governments could be sued for obeying federal orders.<sup>18</sup>

These examples by no means exhaust the recent court decisions that are having significant impact on state affairs. If past is prologue, the federal courts will continue to be a testing ground for the states.

### New Federalism: Another Time Of Testing

Pressures facing states today, however trying, are not in themselves new. States have weathered difficult economic conditions and have coped before with selective federal aid cuts, Congressional appropriations delays, regulatory shifts, and court challenges. Moreover, states face these uncertainties and pressures today in a generally stronger position. Why, then, are the early 1980s a "time of testing" for the states?

The Reagan Administration's New Federalism proposal, by bringing states issues to the fore of national politics, launched a "test" for the states. Virtually overnight, the President's State of the Union Address, in which he unveiled the New Federalism, thrust states into the limelight and put them once again under

<sup>14</sup> Stewart A. Barker and James R. Asperger, "Forward: Toward a Center for State and Local Legal Advocacy," **Catholic University Law Review**, 31:3, Spring 1982, p. 371. Italics added. **Monell v. Department of Social Services**, 436 U.S. 658 (1978) revoked immunity recognized by **Monroe v. Pape**, 365 U.S. 167 (1961). Extension of liability to rights not judicially recognized occurred in **Owen v. City of Independence**, 445 U.S. 622 (1980). Extension of the civil rights statute protection to enforcement of all federal statutes was set out in **Maine v. Thiboutot**, 448 U.S. 1 (1980). See, also, **Middlesex County Sewerage Authority v. National Sea Clammers Association**, 101 S. Ct. 2615 (1981).

<sup>15</sup> 448 U.S. 1 (1980).

<sup>16</sup> 448 U.S. at 22.

<sup>17</sup> **Middlesex County Sewerage Authority v. National Sea Clammers Association**, 101 S. Ct. 2615 (1981).

<sup>18</sup> A.E. Dick Howard, *op. cit.*, p. 415.

## A Balanced Federal Budget And The States

Concern about continuing federal deficits prompted 31 state legislatures to adopt resolutions supporting a Constitutionally mandated balanced federal budget. Eleven of the 31 legislatures adopted resolutions calling for a Constitutional convention to consider a balanced budget amendment and 20 more called for such a convention if Congressional action were not forthcoming. Adoption of a convention call by 34 states would be necessary to implement the state-initiated amendment process outlined in Article V of the Constitution.

The state legislative resolutions were undoubtedly an important factor stimulating Congressional action. On August 4, the Senate approved Senate Joint Resolution 58 which would amend the Constitution to require a balanced federal budget. If the resolution is adopted by the House, the amendment would then have to be ratified by 38 of the state legislatures before it could become part of the Constitution.

A balanced federal budget has many implications for the states. Of particular interest is a deleted part of Section 4 of SJ Res. 58 that, as originally reported out of the Senate Judiciary Committee, stated:

Section 4: The Congress may not require that the states engage in additional activities without compensation equal to the additional costs.

The resolution as it was passed by the Senate did not contain this section. Two Senators raised questions about the provision and it was removed pending further clarification. Senate floor debate on July 29 highlights the pros and cons of the language in question. Senator Orrin Hatch (UT) defended its deletion "because it was superfluous, not because of the intent of the policy was rejected." Senator William Roth (DE) supported its inclusion because, in his words, "The goal of a balanced budget should not be carried in a bucket which leaks, drowning the other governments in the federal system in a flood of costly requirements." Senator Pete Domenici (NM) supported deletion of the language from the Resolution but stated, "I think it should be clearly established in the legislative history on this resolution, however, that we agree with the intent of this original section."

## The State And Local Bond Market

In addition to federal grant cutbacks and recession-induced revenue shortfalls, state and local governments have been hit by yet another whammy: the high cost of borrowing to finance state and local capital projects. At a time when public capital facilities—from bridges to sewer systems—are increasingly regarded as inadequate, this development is surely one that state and local governments do not welcome.

In large part, the borrowing costs of state and local governments reflect the high interest rates prevailing in the economy generally. For example, although we thought long-term municipal bond rates were fairly high historically in 1979—peaking in October at 7.38%—those days are now looked upon fondly as “good old” low interest rates. In contrast, the high for long-term bond yields in 1981 was 13.30%, reached in December. Yields have since fallen to about 12%, still an almost inconceivable return on tax-exempt securities.

Changes in both the demand and the supply sides of the tax-exempt bond market have affected municipal bond interest rates. On the demand side, several recent developments have tended to reduce the attraction of tax-exempt bonds for households and financial institutions alike. Last year's cut in personal tax rates from the top marginal rate of 70% to a top rate of 50% lowered the benefits of holding tax-exempt securities to high-income individuals. Reinforcing this effect is the reduced tax rate on capital gains—now a maximum of 20%—also tending to lure savers away from municipal bonds.

Major institutional investors are finding other investment alternatives, such as tax-sheltered equipment leasing, more attractive than municipal bonds. Fire and casualty companies, presently lacking positive profits, find tax-exempt bonds uneconomic investments and have, temporarily at least, reduced their participation in the municipal market.

The final result has been a substantial decline in net municipal bond acquisitions by institutional investors. According to Federal Reserve Board flow of funds statistics, commercial banks and fire and casualty insurance companies acquired, on net, \$7 billion in municipal bonds in 1981 compared to \$22 billion

in 1980. Consequently, the share of total net new bond issues purchased by commercial banks and fire and casualty insurance companies fell from 81% in 1980 to 27% in 1981. Preliminary data for 1982 shows this trend continuing. In contrast, individual investors, despite the changes in tax law noted above, acquired 58% of new net issues in 1981 compared to only 11% in 1980. However, this increased participation of the household sector is only being obtained by offering sufficiently high interest rates to induce them to forego other investment opportunities.

Developments on the supply side have also been unfavorable. The 1981 Economic Recovery Tax Act increased the supply of securities competing directly with tax-exempt municipal bonds. The new tax-exempt All Savers Certificate is the most obvious example, but the opportunity was also provided for individuals to invest in tax-deferred Individual Retirement Accounts and in assets generating lightly taxed capital gains.

Perhaps the most direct growing competition for traditional state and local government bonds comes from tax-exempt securities of nontraditional sources. These sources include not only private corporations using tax-exempt industrial development bonds to finance capital projects (ranging from fast food franchises to pollution control facilities), but also statutory agencies such as public power and hospital authorities that were not major actors in the market a decade ago.

High interest rates and increased competition for tax-exempt financing will probably be with us for some time to come. Not only will the financing of needed public capital facilities be affected, but high debt service payments may adversely affect current state and local services as well. Despite the phase out of All Savers Certificates at the end of this year and Congressional efforts to restrict private use of tax-exempt industrial development bonds, the municipal bond market will give little fiscal help to state and local governments in their current budgetary battles. —Harvey Galper

scrutiny. No sooner had this major realignment of governmental responsibilities been proposed than people were asking: Will the states be responsive to urban needs? Should anything be done about disparities among states in taxing capacities and their willingness to address human needs? And, has the current recession so buffeted states that they are unable to assume new responsibilities? Underlying these questions is a far more basic one—should states, already spending more than 13% of their own-source revenues on welfare and

Medicaid programs,<sup>12</sup> assume yet greater responsibility for the poor?

However the New Federalism proposals evolve, they initiated a national debate on many issues basic to how our federal system works and created a sense of urgency about them. The answers to the questions raised about state capabilities and responsiveness are beyond the scope of this article; some insight may be gleaned.

<sup>12</sup> ACIR staff calculations

however, by looking at what the states have traditionally done, the relatively new duties they have assumed, and what we expect them to do.

### What Do We Want From Our States?

The New Federalism proposals may have unearthed the "pros" and "cons" of state governments over the past several months, but still unresolved is the question: What do we as a people want them to do? Before we rush to judge them for at least a fourth time this century, this question merits exploration.

Traditionally, the states' role has had many facets. The division of power between the federal government and the states, as set forth in the Constitution, was a system of checks and balances. As Madison argued in *Federalist* 51:

In the compound republic of America, the power surrendered by the people is first divided between two distinct governments. . . . Hence a double security arises to the rights of the people. The different governments will control each other, at the same time that each will be controlled by itself.

As a pluralistic system, federalism was intended to safeguard individual liberty, and its multiple power centers and access points were to enhance governmental responsiveness. Where federalism has failed to serve this objective, notably in the case of racial discrimination, the trend has been towards national governmental action. Overall, however, the states have provided the chief resistance to the centralization of government powers and functions in national hands.

In addition, states have been direct service providers in their own rights, especially in criminal justice, health and hospitals, transportation, higher education, and business regulation. States also have been the prime regulators of public health, safety, welfare, morals, good order, and convenience in the exercise of their police powers. They serve as important innovators of public policies. And it is they who ultimately structure and energize the local governments within their boundaries.

Moreover, states have a long history of administering federal grant-in-aid programs. Currently, they are responsible for intergovernmental financing, regulating and management—functions that require substantial amounts of time and resources. Although these activities always have been on state agendas to some extent, their development as major state responsibilities has been a phenomenon of the post World War II era. At the same time, states have undertaken new programs on their own initiative. Such activities as promoting economic development, protecting consumers, disposing of solid waste, providing public housing, establishing urban enterprise zones, removing hazardous waste, and aiding battered spouses were not traditional items on the state agendas.

Further, state tax systems are now far more equitable than they were just 20 years ago. Many states have exempted food and medicine from consumer sales

taxes; adopted progressive income tax systems; enacted property tax "circuit breakers" for the poor and elderly; and indexed income taxes to compensate for inflation. In short, although exceptions still exist, as a group the states have not shown the callousness toward their less affluent citizens some expected.

Despite the extensive reforms states have undergone and the substantial success they have had in handling the melange of duties they perform, doubts remain about the states' competency in carrying out their obligations. Why do doubts linger? Obviously, memories of civil right abuses, financial scandals, and unresponsiveness are hard to bury completely. And, because states vary, it is always possible to find some states that do not meet certain expectations. But the complete answer perhaps lies in our fundamental ambivalence about what we want the states to do.

### In Defense Of Diversity

The different programs states have adopted and the divergent views their representatives express suggest that they remain differentiated political systems. To a great extent, our assessment of the states and their role in the federal system depends on our tolerance for diversity. Should Skagway, Alaska, for example, be required to install the same kind of secondary treatment facilities for wastewater as cities located on the Cuyahoga River? Do we really want national uniformity in gambling or traffic laws, public sector collective bargaining procedures, right-to-work laws, and a host of other areas where the states traditionally and currently establish their own standards?

In spite of predictions of their demise since the 1930s, the states have survived, in large part because they are an important expression of our diversity. Now, as they are taking measures to cope with recession, federal aid cuts, pressures from local governments and special interest groups, the voters are being asked to make choices. In November, 36 governors and more than 6,000 state legislators will be selected. Undoubtedly, the voters' selections will be uneven and their states' political textures will reflect the varied decisions made on election day.

Before we leap to condemn the states for their unevenness, perhaps we need to evaluate our tolerance for diversity. While a degree of uniformity may be deemed necessary in some areas—such as in aid for the poor—in many others, varied responses are a sign of national health, and may even be counted by some as a necessity. As expressions of strength-giving diversity and as instruments for enhancing that diversity, states are a vital part of our continuing national struggle to maintain a governmental system responsive to, and representative of its people.

*This article is a staff analysis based on the work of Mavis Mann Reeves, consultant to ACIR. Contributors include Stephanie Becker, ACIR Public Information Officer, David R. Beam, ACIR Senior Analyst, and Timothy J. Conlan, ACIR Senior Resident.*



# Community Assistance: The States' Challenge

by Neal M. Cohen

**With the urban crisis of the mid-1960s, local governments moved out from behind the shadow of the state government. City hall and the federal government became inextricably linked to address urban problems. And yet as Washington enacted more and more programs to assist cities, any state efforts to shape urban conditions became, in the words of one federal official, "terra incognita to federal urban policy planners."<sup>1</sup>**

By 1978, however, a quiet, little publicized transition toward a larger state and smaller federal role began. Perhaps rising competence and organizational ability over the past two decades had improved the states' stature. Or, perhaps such change was in deference to the reality that federal resources are limited and, in fact, federal aid to states and localities began declining after 1978 when inflation was taken into account. In recognition of an emerging state urban role, the Advisory Commission on Intergovernmental Relations, at the request of the Department of Housing and Urban Development, in 1979, began monitoring state efforts aimed at directing assistance to local jurisdictions—both urban and rural—in need.

Federal aid cutbacks, the state-orientation of the Reagan Administration's New Federalism proposals, and the recession make ACIR's examination of these state initiatives all the more significant today. ACIR's findings suggest the array of programmatic possibilities available to states with the need and desire to implement them. Additionally, the results to date point to moderate growth in state efforts to target assistance. More important than the simple increase in the number of programs, however, is their apparent tenacity, even in the face of budget cutting and revenue shortfalls. And, finally, ACIR's research indicates the high degree of state activity still necessary if states are to fill the federal aid gap.

This article provides an overview of ACIR's findings on state community assistance programs in 1982 and focuses on the policy instruments—technical assistance, grants or loans, tax incentives and bond subsidies—commonly used in development programs. Finally, examples of state programs using the bond subsidy and tax incentive tools are discussed.

## ACIR's Approach

As the preceding reports did, ACIR's **States and Distressed Communities: The 1982 Report**\* examines 19 different types of programs that states can adopt to aid their distressed communities (see *Figure 1*). The program areas, although they do not exhaust the ways states can address local needs, were derived from polling state and local officials about the most important actions that states might take to aid distressed jurisdictions.

The 19 programs fall into five general categories: housing, economic development, community development, fiscal and financial management assistance, and programs that enhance local capabilities (see box on page 19 for discussion of state activity in the five categories of aid). The development programs—including the categories of housing, economic development, and community development—generally provide direct state aid for specific purposes such as housing rehabilitation or small business subsidies. These programs, where local entities apply for specific project funds, tend to be budgeted at relatively low amounts.

<sup>1</sup> Larry Houston, "Urban Policy: What Else is New?" *Urban Land*, July-August, 1978, p.6.

\*The 1982 Distressed Communities report has not yet been published; however, the 1981 volume is available from ACIR.

Figure 1

Indicator	Number of states with program	New England				Midwest				Great Lakes				Plains				Southeast				South west				Rocky Mountain				Far West																													
		Connecticut	Maine	Massachusetts	New Hampshire	Rhode Island	Vermont	Delaware	Maryland	New Jersey	New York	Pennsylvania	Illinois	Indiana	Michigan	Ohio	Wisconsin	Iowa	Kansas	Minnesota	Missouri	Nebraska	North Dakota	South Dakota	Alabama	Arkansas	Florida	Georgia	Kentucky	Louisiana	Mississippi	North Carolina	South Carolina	Tennessee	Virginia	West Virginia	Arizona	New Mexico	Oklahoma	Texas	Colorado	Idaho	Montana	Utah	Wyoming	California	Nevada	Oregon	Washington	Alaska	Hawaii								
<b>HOUSING</b>																																																											
1. Single-Family Home Construction	46	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•				
2. Multifamily Home Construction	10	•		•	•				•	•																																																	
3. Housing Rehabilitation Grant or Loan	13	•		•			•	•	•	•			•		•					•																																							
4. Housing Rehabilitation Tax Incentive	15	•		•				•	•	•			•		•				•																																								
<b>ECONOMIC DEVELOPMENT</b>																																																											
5. Industrial or Commercial Site Development	7							•		•			•	•												•																																	
6. State Financial Aid for Industrial or Commercial Development	19	•		•			•	•	•	•			•	•	•	•				•								•																															
7. Customized Job Training	4			•						•																																																	
8. Small Business Development	13	•		•			•	•	•	•			•		•				•									•																															
9. Industrial Revenue Bonds	12	•		•				•				•			•				•																																								
<b>COMMUNITY DEVELOPMENT</b>																																																											
10. Capital Improvements	16	•		•				•		•																																																	
11. Local Neighborhood Improvement Efforts	16	•		•			•	•	•	•			•	•		•				•																																							
<b>FISCAL REFORM</b>																																																											
12. State Revenue Sharing	23		•	•	•			•				•	•	•						•							•			•																													
13. Education Finance Reform	11	•		•								•	•																																														
14. Assumption of Local Public Welfare	30	•	•	•	•	•	•	•	•	•		•	•	•					•							•	•			•																													
15. Reimbursement of State-Mandated Programs	12			•	•								•	•																																													
16. Improving Local Governments' Access To Credit Markets	41	•	•	•	•	•	•	•	•	•		•	•	•	•	•				•						•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•		
<b>ENHANCING LOCAL CAPABILITIES</b>																																																											
17. Local Use of Tax Increment Financing	28	•	•	•	•			•				•	•	•	•	•				•																																							
18. Local Sales or Income Taxing Authority	36						•	•	•	•	•	•	•	•	•	•				•					•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•	•		
19. Local Discretionary Authority	16	•	•				•	•		•		•	•							•																																							

Source: ACIR, States and Distressed Communities 1982 Report (draft).

The fiscal/self-help policies include the categories of fiscal reform and local self-help. Under the fiscal reform category are state actions that attempt to correct local fiscal imbalances either by distributing statewide aid according to an equalizing formula or by assuming local program or regulatory costs. These policies generally demonstrate a state's willingness to assume the burden of significant local costs in, for example, education, health and welfare. The self-help programs include those that grant local governments authority to assist themselves without direct state involvement or expenditure, such as allowing local sales or income taxes or tax increment financing.

Figure 1 indicates which types of programs each of the 50 states has adopted. Only programs that rely on state funding and are designed to assist distressed communities were considered. Distressed communities are defined as "any areas, including various types of general units of local government in rural, urban and suburban places, which are declining or in need in relation to other areas of the state." Although the distress criterion used is not a stringent one, it does allow a distinction to be made between programs that are available to all localities, regardless of need, and those with eligibility requirements.

Although most of the programs are targeted to specific geographic areas, some are tailored for specific population groups such as the low income, the elderly or members of minority groups. Many housing programs, for example, are targeted by income, and certain small business development programs are intended to help entrepreneurs from socially or economically disadvantaged backgrounds.

Some caution must be exercised in drawing conclusions from Figure 1. Although the information does provide a rough guide to state activity on behalf of distressed communities, it does not necessarily indicate a state's overall effort to aid localities. Also, because of varying conditions in the states, not all of the program types are necessarily appropriate to each state. Some predominantly rural states, for example, may have little need for programs designed specifically for cities. In addition, because the list of program types is not exhaustive, some states may have effective programs that are not included.

#### ACIR's 1982 Results

At first glance, it would be easy to surmise that little changed since ACIR surveyed the states for the 1981 report of *The States and Distressed Communities* (see Table 1). Between 1981 and 1982, the number of states that adopted or dropped each type of program generally increased or decreased by just two or three states. Many totals remain the same. By themselves, however, the numbers do not reveal a complete story of state activity last year.

For instance, the catalog of 1982 programs makes one point clear: states that have been committed to helping their distressed communities are now reaffirming that commitment with new programs. These new programs do not change the indicator totals because the states in

Table 1  
NUMBER OF STATES WITH PROGRAMS IN  
ACIR's 19 INDICATORS OF AID

Indicator	1982	1981
<b>HOUSING</b>		
1. Single-Family Home Construction	46	45
2. Multifamily Home Construction	10	8
3. Housing Rehabilitation Grant or Loan	13	14
4. Housing Rehabilitation Tax Incentive	15	17
<b>ECONOMIC DEVELOPMENT</b>		
5. Industrial or Commercial Site Development	7	6
6. State Financial Aid for Industrial or Commercial Development	19	16
7. Customized Job Training	4	3
8. Small Business Development	13	11
9. Industrial Revenue Bonds	12	11
<b>COMMUNITY DEVELOPMENT</b>		
10. Capital Improvements	16	16
11. Local Neighborhood Improvement Efforts	16	14
<b>FISCAL REFORM</b>		
12. State Revenue Sharing	23	23
13. Education Finance Reform	11	18
14. Assumption of Local Public Welfare	30	25
15. Reimbursement of State—Mandated Programs	12	14
16. Improving Local Government's Access To Credit Markets	41	35
<b>ENHANCING LOCAL CAPABILITIES</b>		
17. Local Use of Tax Increment Financing	28	24
18. Local Sales or Income Taxing Authority	36	36
19. Local Discretionary Authority	16	16

Source: ACIR, *States and Distressed Communities*, 1981 report and 1982 (draft).

question already have been counted for earlier programs that still may be operating. Michigan's Economic Development Authority and Maryland's new enterprise zone legislation are good examples of state programs that replace more limited incentives approved the year before.

In addition, simply maintaining program levels in the

current economic climate is an optimistic sign. Programs specifically targeted to distressed areas within the state are likely to slip on many a lawmaker's list of priorities as state treasuries come under increasing strain. Working under constitutional, statutory or traditional balanced budget requirements, many state legislatures have been forced to raise taxes, reduce expenditures or both in an effort to continue to fund existing programs. Some—among them, Arizona, Connecticut, Idaho, Kentucky, Michigan, Oregon, Nebraska and West Virginia—have approved across-the-board spending cuts, exempting high-priority programs; and, limited budget reductions enacted in other states resulted in deferred capital spending or reductions in the state workforce. The tenacity of these state programs during times of economic and budgetary duress is, in itself, a testimony to their popularity among legislators.

### State Activity In The 19 Categories

The modest increases readily visible for individual programs are reflected as well in the total number of program types counted for each state. As in last year's report, Massachusetts, counted in 16 areas, is again the only state with programs in more than 15 of the 19 categories. The number of states with programs in 12 to 14 of the categories climbed from four to seven, and now includes California, Connecticut, Michigan, Minnesota, New Jersey, Pennsylvania and Wisconsin. The total for states with programs in nine to eleven of the categories slipped from nine to seven, while those states active in five to eight program areas added another to their number, for a total of 28. The number of states with only one to four programs dropped from nine to seven.

Blanket conclusions about the regional distribution of the community assistance programs are difficult. When ranking the regions according to those with the greatest number of programs, the frostbelt states, led by the Mideast and Great Lakes regions, top the list (see *Table 2*). The Far West ranks third followed closely by the Northeast.

Frostbelt-sunbelt differences are more apparent when the 19 indicators are broken into the two subcategories—development programs and fiscal self-help reforms. For instance, development programs are largely a frostbelt phenomenon. The Mideast, Great Lakes and Northeast states have the greatest number of these programs and the Southwest and Southeast regions have significantly fewer.

In the fiscal self-help categories, a regional pattern is not as readily apparent. While the sunbelt regions generally favor fiscal self-help programs, the frostbelt states have enacted a significant percentage of these programs as well. Thus, although one can expect the frostbelt regions to favor development-type policies, the fiscal self-help programs are less likely to be concentrated in particular regions. These patterns are not too surprising because development programs are more apt to be targeted to northern and eastern cities where the roads, sewer systems and housing stock are older. Fiscal reforms, which generally require either a state's

Table 2

### PERCENTAGE OF THE 19 INDICATORS ENACTED IN U.S. REGIONS, 1982

	Total	Development	Fiscal/Self-Help
<b>Mideast</b>	54.7	60.0	47.5
<b>Great Lakes</b>	51.5	40.0	67.5
<b>Far West</b>	43.8	34.8	56.3
<b>Northeast</b>	42.1	36.3	50.0
<b>Plains</b>	36.8	27.2	50.0
<b>Southwest</b>	35.5	21.4	56.3
<b>Southeast</b>	29.3	20.4	41.7
<b>Rocky Mountain</b>	26.3	21.8	32.5

Source: ACIR staff calculations based on *The State and Distressed Communities* 1982 draft report.

authorization of a local power or enactment of an equalizing local aid policy, are unrelated to a community's age. Rather than resulting from factors indigenous to a particular region, such reforms are probably more influenced by the degree of state fiscal and administrative centralization.

### State Development Policies: Their Design And Implementation

When all of the programs have been added up, the question of their effectiveness remains. While *The States and Distressed Communities* report identifies and describes state efforts targeted to needy areas, ACIR has not attempted a detailed analysis of each program's implementation record. However, the research did include a detailed look at a number of widely implemented policy instruments. The analysis of one state's experience with these instruments permits a cautious generalization of how they might operate in another. The assumption is that each of these four predominant tools—technical assistance, grant or loan, bond subsidy, and tax incentive—carries with it "a substantial amount of 'baggage' in the form of its own characteristic implementing institutions, standard operating procedures, types of expertise and professional cadre, products, degree of visibility, enactment and review processes, and relationships with other societal forces."<sup>2</sup>

To confine the analysis, the remainder of the article focuses on the development policies. In the pages to follow, then, the four principal development tools will be described and the two most widely used policy instruments—the bond subsidy and the tax incentive—will be looked at more closely.

<sup>2</sup> Lester M. Salamon, 'Rethinking Public Management: Third Party Government and the Changing Forms of Government Action' in *Public Policy*, Volume 29, No. 3, Summer 1981, p. 264.

## Technical Assistance

Technical assistance programs generally are designed to assist smaller communities that may need to improve their administrative or financial practices. Alabama's Prepared Cities Program represents a prototypical use of technical assistance. Towns, with a population under 20,000, are offered a self-help program to become competitively attractive to industrial developers. The state has prepared a handbook for eligible jurisdictions containing step-by-step guidelines for local leaders to follow in preparing their area and will also send out a team *pro bono*, to conduct a "community evaluation." As such, the program is not expensive for the state to operate, but does demand a lot of local energy and commitment. Like many programs that use technical assistance, Alabama's policy lives or dies by the philosophy that those communities that want to help themselves will help themselves.

## Grant Or Loan

A grant or loan policy generally allows private firms to seek state funds to start or expand businesses. In general, these programs are not designed to reduce the cost of capital to firms (most charge interest rates for loans 2-4 points above prime) but rather to assure the availability of capital. In Washington, for example, the Community Economic Revitalization Board (CERB), formerly known as the Economic Assistance Authority, was established to entice industry into the state and reduce unemployment. The legislature chose grants and loans as a way to funnel funds quickly into designated high unemployment areas.

## Bond Subsidies

Bond subsidies, unlike the grant or loan, do attempt to reduce the cost of capital. Through either a tax exempt industrial or mortgage revenue bond or a guaranteed general obligation bond, the state tries first to attract business investment within its boundaries by reducing the cost of borrowing. Then, because most states do not impose any location restrictions on tax exempt bonds, the bond subsidy is coupled with a tax abatement to influence a business' decision to locate in a distressed area. In Connecticut, for example, the Self-Sustaining Bond Program provides industrial revenue bond financing for up to 100% of the cost of specific industrial projects as well as certain recreational and utility projects. With the bonds exempt from federal and most state income taxes, a lower financing cost is possible. Moreover, tax abatements are offered to businesses locating in designated areas.

The general obligation (GO) bond usually offers an even lower interest rate because it is backed with the full faith and credit of the state. Oregon's Elderly Housing Finance Program uses GO bond financing to keep long-term mortgage loans at the lowest possible interest rates.

## Tax Incentives

Tax incentives are a fourth instrument used to induce private development into a distressed area. These in-

centives take numerous forms. For example, Virginia's housing rehabilitation tax exemption attempts to influence homeowners' decisions to rehabilitate the housing stock by offering a property tax deduction when buildings 25 years or older are improved and the assessed value of the structures are increased by no less than 40%. By reducing tax rates, then, the state hopes to encourage redevelopment.

Another type of tax incentive is a credit to businesses or individuals that provides assistance either to occupants of, or a physical plant in distressed areas. States offer these credits to help community groups increase jobs or provide employee training. The Neighborhood Assistance Credit Program in Indiana is an example of a program that offers a 50% tax credit on state income taxes to businesses and individuals that assist local neighborhood organizations in upgrading economically disadvantaged areas.

Of these four policy instruments, the bond subsidy and tax incentive are the most widely used. The following section discusses the implementation record of these two popular tools in specific state programs.

### A Closer Look:

#### Revenue Bonds In Tennessee and Connecticut

Both Connecticut's Self-Sustaining Bond Program and Tennessee's *Central Business Improvement District Act* try to target revenue bonds by offering tax relief to firms receiving bond financing in designated areas. Although bond subsidies are available to developers regardless of site location, the states try to steer them to particularly distressed areas with the added tax break. Hence, manufacturing firms locating in qualifying areas in Connecticut may receive, among other things, a tax abatement of 80% of local property taxes for five years and 25% of the state corporate business tax for ten years. In Tennessee, bond-financed developers working in specially designed districts are allowed a 15-year property tax freeze with gradual escalation to normal value over a subsequent ten-year period.

The two programs differ in their administrative features and the extent of their objectives. In Connecticut, the program is state administered and designed to aid 21 cities and towns in economically distressed areas and 38 cities and towns in areas of high unemployment. By definition, the program's objectives are long term: to improve the economic and employment capacity of the designated communities through a combination of bond financing and tax abatements.

Connecticut is trying to increase the impact of the bond subsidy on distressed areas by giving businesses receiving a bond subsidy a choice: they can either locate in any Connecticut community or they can seek a tax abatement and have their location options restricted. When businesses do not choose the latter course, the impact of the Connecticut Self-Sustaining Bond Program is diminished.

Tennessee's *Central Business Improvement District Act* allows local governments to designate qualifying areas and to issue revenue bonds themselves. Memphis, the principal beneficiary of the state law, is attempting to improve a



## State Activity In The Five General Categories Of Aid

**Housing.** Although states have played an increasing role in providing housing for low and moderate-income persons, they came to it later than their local and federal partners. When the federal housing programs burgeoned during the 1930's, state efforts generally were limited to authorizing local public housing authorities. Today, the states have moved beyond authorization and regulation of local efforts to heavy involvement in programs that provide or improve housing, usually through state housing finance agencies (HFA's). Forty-six states have single-family housing assistance programs, usually related to subsidies offered by tax-exempt mortgage bonds; ten states provide aid for multifamily housing exclusive of federal Section 8 assistance; 13 states provide rehabilitation grants or loans; and, 15 offer tax incentive for selective housing rehabilitation.

**Economic Development.** Many states have seized an array of economic development tools to stimulate commercial and industrial activity within their borders. As in the other development categories, ACIR has tallied only those state programs that are targeted to distressed areas or needy individuals.

ACIR's research indicates that seven states aid their localities by assisting with initial industrial development in rural areas and industrial redevelopment in older urban locales; 19 states provide some type of financial aid for businesses locating in declining areas; four states have customized, targeted job training programs; 13 have special programs for small businesses; and 12 direct their industrial revenue bond subsidies to projects in distressed areas.

**Community Development.** Community improvement and neighborhood assistance programs represent potentially complementary state efforts to build vital communities. The former category directs "bricks and mortar" to hard-pressed local governments for necessary services such as roads, water, sewer treatment and schools. The latter policy is more concerned with maintaining and upgrading an area's housing, economic health or community services.

Targeted capital improvement efforts—adopted in 16 states—make their strongest showing in many of the energy-rich states where "boom towns" with rapid and unexpected growth need public facilities. Other states, faced with declining urban and rural areas, target capital assistance for replacing and maintaining facilities. Neighborhood improvement programs, in place in 16 states, are geared mainly to drawing on private resources and encouraging efforts by community residents.

**State Financial Aid.** State financial assistance—either directly or through assumption of local burdens—has become an essential component in most

state-local fiscal systems. Many states have attempted to aid their localities most by assuming a greater share of the "big ticket" items, especially local education, health and welfare costs.

ACIR examined those forms of state aid that are targeted on a "need" basis. For example, in revenue sharing, 49 states have some kind of sharing program with their localities, amounting to about \$6.6 billion in 1977; of these, 23 states target the funds according to need.

In education finance, states accounted for about half of all elementary and secondary school costs in 1981, reflecting the fact that 27 states assumed more than half of local education expenses and all but three states contributed more than 30%. Spurred by court decisions, many states have sought to distribute education funds so as to reduce disparities in per pupil spending between rich and poor school districts. According to the Education Commission of the States, 27 state legislatures have instituted an education finance reform policy. Of these, 11 succeeded in significantly reducing per pupil spending disparities.

In public welfare, 30 states now assume at least 90% of state and local public welfare expenditures (including Medicaid). Only two states provide less than half of these costs. State and local welfare-related expenditures amounted to \$22.2 billion in 1980, to which the states contributed over 86%.

In the case of reimbursement for state mandates, 12 states reimburse local governments for the costs incurred to conform with laws and executive orders that require new programs or increased levels of service. Finally, in the local credit market access category, ACIR counted 41 states that support local borrowing efforts in at least one of four ways: (1) bond validation; (2) state guarantees of debt; (3) state assistance as a financial intermediary; and, (4) state aid for local debt service payments.

**Enhancing Local Self-Help Capabilities.** Many policymakers are now convinced that, for too long, the growth of federal grants to state and local governments obscured the need for fundamental changes in the way cities, counties and towns structure and finance their operations. Enhancing local governments' ability to help themselves is frequently offered as a solution to many of the problems facing distressed communities. Currently, 44 states provide at least one of these three forms of local authority ACIR studied. Specifically, 28 states authorize their local governments to use tax increment financing as a development tool; 36 states allow their localities to assess either a sales or an income tax, and, in a few cases, both; and, 16 states provide their local governments with broad discretionary authority.

**“Both the Connecticut and Tennessee programs assume, first, by reducing the costs of borrowing, businesses can be attracted to their states; and second, that businesses can be influenced to locate in a distressed area by selective tax abatements. But these assumptions are being widely challenged.”**

blighted area in its downtown within a relatively short time. Initially, Memphis developers sought to construct high-priced housing. Wagner Place, a 104-unit luxury high rise condominium, and Riverbluff, a development of 37 luxury townhouses, were constructed with industrial revenue bond financing. In 1980, however, the number of residential projects decreased substantially when Congress required that 20% of bond-financed units be set aside for low and middle-income persons.

Because Memphis' redevelopment area proved attractive to many "blue-chip" developers, subsidized financing and the property tax freeze became concomitantly less critical. Of the 34 projects begun in the improvement district, only 14 have been financed with revenue bonds. The other 20 projects are being financed privately. Moreover, only 17 of the 34 projects received the ten-year property tax freeze. Developers appear to have been attracted by the Memphis community leaders' commitment to a revitalized and fashionable "old town" area by the riverfront rather than by the subsidies themselves.

#### **Targeted Bond Subsidies Considered**

Both the Connecticut and Tennessee programs assume, first, by reducing the costs of borrowing, businesses can be attracted to their states; and second, that businesses can be influenced to locate in a distressed area by selective tax abatements. But these assumptions are being widely challenged. With respect to the bond subsidy, a recent report argues that "the cost of capital savings do not amount to much in light of total production costs or market differences among states, even in a region with similar production costs among the states."<sup>3</sup> With respect to tax abatements, the same analysis reports that "the best available evidence suggests that the real effect of state taxes on investment location is grossly exaggerated. Taxing businesses at prevailing levels makes little difference. . ."<sup>4</sup>

Still, like the dying atheist who calls for a clergyman, many states prefer not to risk omitting either bond subsidies or tax abatements from their arsenal of weapons to target development—these economic development

tools may have only marginal value but, then again, they may not. The Connecticut and Tennessee programs rest on the belief that some businesses or developers wishing low-interest financing also need the added incentive derived from tax abatement.

#### **A Closer Look:**

##### **Neighborhood Tax Credits In Indiana and Delaware**

Indiana and Delaware issue tax credits or deductions to influence corporate philanthropic behavior toward neighborhood and community groups working in distressed areas. While the two programs share similar objectives they work in slightly different ways. The success of the Indiana Neighborhood Assistance Credit Program (NAP) is clearly contingent upon local action. A neighborhood group must initiate application to the state for the tax credit. The local groups can then offer this credit to contributing businesses or individuals. Under Delaware's *Neighborhood Assistance Act*, the donor, rather than the recipient of the contribution, takes the initiative. A corporation first contributes to an eligible neighborhood group and then applies to the state for a deduction from its state taxes.

Both the Indiana and Delaware programs have been hampered by a lack of marketing. In Indiana, participation in the program is so low that the annual \$1 million in available tax credits set aside by the Indiana General Assembly has never been spent. For example, in the 1978-79 fiscal year, the first year of authorization, only \$39,915 in NAP tax credits were actually allocated to contributors. The following year, \$29,640 in tax credits were used, the next year \$73,007, and, by June the 1981-82 fiscal year total stood at \$55,694. According to the records kept by the Indiana Department of Commerce, no more than 15 community groups have participated in the program from the 1980-81 fiscal year to the present.

Similarly, Delaware's *Neighborhood Assistance Act* is underused. The Delaware Tax Appeal Board, whose job it is to accept and assess applications for the tax deduction, approved just four proposals totalling \$17,400 in the 1980-81 fiscal year. Only three corporations participated in the program, all of which contributed to neighborhood groups located in Wilmington.

##### **Targeted Tax Credits Considered**

The two states' neighborhood assistance policies, intended to influence business contribution decisions, suggest several problems associated with the tax credit. In Indiana, in addition to marketing problems, organizational factors have hindered program effectiveness. Local groups often are plagued by a Catch-22 dilemma: to tap the program's benefits, staff members must first find a donor and then apply for the tax credit—the group may find that its work suffers when attention is diverted from providing the community services for which the organization was established. Caught by this paradox, the local groups may do neither activity as well as they might wish.

In Delaware, the incentive's weak appeal impairs the effectiveness of the strategy. The state tax deduction for

<sup>3</sup> Lawrence Litvak and Belden Daniels, *Innovations in Development Finance*, Washington, DC, The Council of State Planning Agencies, 1979, p. 101.

<sup>4</sup> *Ibid.*

**“These state “snapshots,” and the questions they raise, point up the difficulty of gauging how effective bond subsidies and tax incentives are in targeting development.”**

broader array of assistance programs for hard-pressed communities. Chicago Mayor Jane Byrne's comments during the July 1982, annual meeting of the Conference of State Legislatures offered some cause for optimism: "We are not cities alone. We are not legislatures alone. We are not upstate or downstate. It's time we realize we are all in this together."

corporate contributions is a relatively paltry tax break, especially when a federal deduction is already forthcoming. In interviews conducted with the three participating corporations, ACIR found that each made its donations based on considerations other than the potential state tax savings.

### **Designing Effective State Community Assistance Programs**

The discussion of these development tools, along with examples of their implementation record, suggests issues to keep in mind when designing programs for distressed communities. For instance, how should a program be marketed? Are the incentives strong enough to cause the desired action? Would a business aid the distressed area even without the incentive? Does the program require so much staff time that organizations are diverted from their original purpose?

These state "snapshots," and the questions they raise, point up the difficulty of gauging how effective bond subsidies and tax incentives are in targeting development. Equally important, they point up the need for such a measurement. State decisionmakers need to be able to determine whether a program is meeting its goals and whether it represents the most effective use of state tax dollars. That task is especially difficult when programs, like those just considered, require little or no direct expenditure of state funds.

State policymakers are at a critical juncture. They can either begin or expand community assistance initiatives or leave the void created by federal program cuts. The Reagan Administration contends that, as the federal-local role is reduced, it is up to the states to shape their own destinies, including the future of their localities.

The ACIR study demonstrates a growing state commitment to community assistance. States are asserting their status as "laboratories" of federalism with the enactment of enterprise zones and neighborhood development programs. Further, quite a number of states have substantially removed the albatross of welfare and education costs from the local government neck. Illinois, Michigan, Missouri, Oklahoma and five other states have assumed over 99% of local public welfare costs. Twenty-seven states, as of 1981, had assumed more than half of local education costs. With education and welfare costs consuming the lion's share of state-local expenditures, state efforts in these areas are commendable. Nevertheless, as federal aid continues to be cut and local governments cry "help," states may need to reassess their ability and willingness to offer a

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# Municipal Revenue Behavior After Proposition 13

By Robert J. Cline and John Shannon

**After more than two decades of sustained growth in real government expenditures, municipal finance went through a fundamental restructuring in the 1977-80 period. Sharply increasing property taxes, accompanied by little or no growth in real personal income, precipitated what has come to be called the "taxpayer revolt." New state-imposed limits on local governments, along with a reduction in the real value of federal aid, intensified the fiscal pressures on municipal budgets. Cities have responded to this pressure by diversifying their local revenue structure.**

From 1977 to 1980 the pace and, in some cases, the direction of the long-run trends in city revenue sources were altered substantially as *Table 1* illustrates. Particularly significant is the accelerating decline in the share of municipal revenues raised through property taxes and the sharp upswing in user fees and other nonproperty-tax revenues. The property taxes' relative decline can be partly attributed to the adoption of new state constraints on local expenditures and revenues during this period. Proposition 13 in California and Proposition 2½ in Massachusetts are examples of limitations that actually rolled back property tax rates and further limited the rate of increase in the local property tax base. Because the vast majority of the state restrictions relate only to the property tax, city officials are encouraged to expand the use of nonproperty tax revenues, including local sales taxes and benefit-based user charges and fees. The upsurge in the use of service charges reflects the most logical way for local policymakers to reconcile the need for more revenue with the realities of voter resistance to increased property tax levies.<sup>1</sup>

This article discusses the growth in state limitations on local governments and their impact on the revenue structure of municipalities. The changing composition of local revenues is documented by a survey conducted by the Advisory Commission on Intergovernmental Relations (ACIR) in collaboration with the Municipal Finance Officers Association (MFOA). The analysis of the survey results will focus on the increasing importance of user fees in the local revenue mix.

## The Influence of State Restrictions on Local Governments

Although state restrictions on local taxing authority are not a new development, the pace of adopting state-imposed lids has recently increased substantially and has also changed decisively in character. The older, traditional type of state restraint focused solely on the property tax. Indeed, all of the 31 state limits enacted before 1970 restricted the authority of local officials only with regard to the property tax and 29 of these 31 pertained solely to the property tax rate. *Figure 1* provides a comprehensive listing of state-imposed limits on local expenditures and revenues, as well as limits on state governments.

As a device for restricting the growth of local governments, property tax limits alone have proved insufficient. Restricting access to only one of the fiscal resources left local officials free to pursue several "escape hatches"—in other words, local diversification.

States added 32 more restrictions in the eight years

<sup>1</sup>User charges are defined by the Census Bureau as "amounts received from the public for performance of specific services benefiting the person charged and from sales of commodities and services, except those by liquor store systems and local utilities." Special assessments are mandatory payments from property owners who are assumed to benefit directly from public improvements. The other miscellaneous revenues category includes rents and royalties, proceeds from the sale of property and interest earnings. The sharp increase in the relative share of this category primarily reflects the growth in the interest component. Interest earnings equaled 47% of miscellaneous revenues in 1980 compared to 35% in 1977.

Table 1

**The Shifting Significance of Municipal Finance Sources<sup>1</sup>**  
**1957-77 vs. 1977-80**

	1957-77	1977-80
<b>Federal Aid</b>	Rising Rapidly (from 1.0% to 24.2%)	Falling Slowly (from 24.2% to 22.8%)
<b>State Aid</b>	Rising Rapidly (from 19.8% to 38.5%)	Falling Moderately (from 38.5% to 33.4%)
<b>Property Tax</b>	Falling Steadily (from 57.1% to 42.7%)	Falling Sharply (from 42.7% to 35.3%)
<b>Non-property Taxes</b>	Rising Steadily (from 21.4% to 28.5%)	Rising Moderately (from 28.5% to 30.1%)
<b>User Charges</b>	Rising Steadily (from 12.7% to 18.6%)	Rising Rapidly (from 18.6% to 20.7%)
<b>Special Assessment</b>	Falling Steadily (from 2.9% to 1.4%)	Holding Steady (from 1.4% to 1.5%)
<b>Other Miscellaneous Revenues</b>	Rising Slowly (from 6.0% to 8.8%)	Rising Sharply (from 8.8% to 12.4%)

<sup>1</sup> The totals exceed 100% because all components are expressed as a percent of own-source municipal revenues.

SOURCE: ACIR staff calculations derived from U.S. Department of Commerce, Bureau of the Census, *City Government Finances*, various years.

from 1970 to 1977 to the 31 adopted in the pre-1970 period. The states completed their arsenal of property tax curbs by adopting two new types of restrictions—limits on assessment increases and provisions for the full disclosure of property tax increases. The 1970s also witnessed the emergence of a new type of lid law—the TEL, that is, the tax or expenditure limit. While the TELs differ in detail, they share the characteristic of being more comprehensive in scope than restrictions applied only to the property tax. In general, the TELs limit the overall increase in local revenues or expenditures, with increases usually tied to a percentage change from a base year figure or to the growth in personal income. Adjustments are sometimes allowed for changes in the cost of providing public services—measured by population growth or changes in the consumer price index, for example. Being more comprehensive in scope, these TELs include local sales and income taxes as well as nontax revenues, such as user charges, in their more restrictive net.

Although TELs are the new and growing entry on the restriction list, property tax limits still dominate. Compared to the pre-1970 years, when all 31 state lid laws related solely to the property tax, only 23 of the 32 limit laws enacted between 1970 and 1977 curbed the access of local officials to the property tax. Since 1977 states have enacted an additional 29 lid laws—almost equalling the 32 adopted over the 1970-79 period and the total of 31 enacted any time prior to 1970. Twenty-five of the 29 lids adopted since 1977 apply only to the property tax, while the four new TELs are equally divided with two restricting local expenditures and two limiting revenue growth. The rate of adoption of state

limits, however, has now slowed considerably with only two new limit laws being imposed in the last year.

The vast majority of total state restrictions—79 of the 92 currently in place—pertain solely to the property tax. The adoption of property tax limits reflects in large part continuing increases in the share of total property taxes paid by homeowners. Although the property tax fell from 57.1% of local own-source revenues in 1957 to 42.7% in 1977, higher relative rates of inflation in residential housing prices and increased business property tax exemptions resulted in an increase in the share of property taxes paid by residential property as compared to the share paid by commercial and industrial property. In Michigan, for example, the share of residential property in total state equalized value increased from 49.2% to 56.5% of the total between 1972 and 1980. Similarly, in California the homeowners' share of total net assessed value increased from 33.7% in 1971-72 to 43% in 1978-79. Ironically, one important result of Proposition 2<sup>1/2</sup> in Massachusetts appears to be an increase in the relative burden of property taxes on homeowners as statewide property assessments are updated to reflect full market values in FY 1982.<sup>3</sup>

### The Local Government "Escape Hatch"

Local governments can pursue a number of "escape hatches" in diversifying their revenue structures. The most direct approach is to increase revenue sources that are not constrained by state-imposed limits. In this case, the partial coverage of limit laws provides a "tilt" toward local sales and income taxes, special assessments and user charges and fees. Local governments can indirectly diversify their revenue structures by transferring certain activities, such as municipal water and sewer facilities, to independent authorities exempted from limit laws. The independent authorities or special districts collect user fees, rather than property taxes, to cover the cost of their services.

A third option available to local policymakers is "privatization" of a public service. This alternative involves transferring local government activities to private firms that charge consumers directly for the services provided. For example, municipal refuse collection could be turned over to a private firm operating under a government franchise. Summer school classes in California were provided on a user fee basis by private firms and volunteer groups when local school districts cancelled summer activities following the adoption of Proposition 13.

Another form of privatization is expanding use of the special fees and assessments collected from developers to finance capital facilities needed to service new residents and businesses. In California, local govern-

<sup>3</sup> A detailed analysis of the first-year fiscal effects of Proposition 2<sup>1/2</sup> in Massachusetts is found in Katherine L. Bradley and Helen F. Ladd, "Proposition 2<sup>1/2</sup>, Initial Impacts, Part I and Part II," *New England Economic Review*, January February and March April 1982. The data on residential property tax shares are from Paul N. Courant, "The Property Tax," in Harvey E. Brazer, ed., *Michigan's Fiscal and Economic Structure* (University of Michigan Press, 1982) and William H. Oakland, "Proposition 13—Genesis and Consequences," *National Tax Journal*, Vol. XXXII, No. 2, Supplement, June 1979.



## RESTRICTIONS ON STATE AND LOCAL GOVERNMENT

States	State-Imposed Limits on Local Governments							
	Overall <sup>1</sup> Property Tax Rate Limit	Specific <sup>1</sup> Property Tax Rate Limit	Property Tax Levy Limit	General Revenue Limit	General Expenditure Limit	Limit on Assessment Increases	Full Disclosure	Limits on on State Governments
	14	29	20	5	8	6	10	19
<b>Total</b>								
Alabama	CMS***	CMS*						
Alaska	CMS**		CM**					Const.***
Arizona	CMS***		CM***		CMS***	CMS***		
Arkansas		CMS*	CMS*** <sup>2</sup>					Const.***
California	CMS***				CMS***	CMS***		
Colorado		CS*	CM*		S**		CMS***	Stat.**
Connecticut								Const.***
Delaware		CS**	C*** <sup>2</sup>					
District of Columbia							CMS**	
Florida		CMS*	CMS***					
Georgia		S*					C**	Const.*** Stat.***
Hawaii								
Idaho	CMS***	CMS*	CMS***					
Illinois		CMS*						
Indiana			CMS***					
Iowa		CMS*			S**	CMS**		
Kansas		CM*	CM**		S**			
Kentucky	CMS*						CMS***	
Louisiana		CMS**	CMS*** <sup>2</sup>					Stat.***
Maine						CM**	CM**	
Maryland								
Massachusetts	CMS***		CMS***					
Michigan	CS*	M*	CMS***				CMS***	Const.**
Minnesota		CMS**		CM**	S**			
Mississippi		CMS*	CMS***					
Missouri		CMS*		CMS***				Const.***
Montana		CMS*					CMS**	Stat.***
Nebraska		CMS*		CMS***				Stat.***

increased development fees sharply following the mandated rollback in local property taxes. A survey of California cities six months after the passage of Proposition 13 found that 56% of the cities and 57% of the counties responding increased development fees. In cities reporting increased service fees, the average increase was 90%.<sup>3</sup> Overall, benefit-related fees and charges grew from 22% of all local revenues in FY 1976 to 24% in FY 1980. Actual benefit-related charges increased by 55% over this period for all local governments in California. Information concerning the extent of recent local diversification efforts across the United States is presented in the next section.

### The ACIR-MFOA Survey

If the property tax has undergone a long-term decline—and one that has quickened in pace since 1977—what has taken its place as municipal governments diversify their revenue structures? The quick—and reasonably accurate—answer is “everything” else. To track city nonproperty tax actions, the Advisory Commission on Intergovernmental Relations, in collaboration with the Municipal Finance Officers Association, conducted a national survey of 595 municipal finance officers. Based on 438 replies, the following questions and answers highlight developments in municipal revenue diversification during 1980 and 1981.

**Just how widespread is the movement to diversify municipal revenue systems through greater use of nonproperty tax sources in general and**

<sup>3</sup> Reported in Dean J. Misczynski, *California's Nonplunge into Benefit Levydom*, paper prepared for the Lincoln Institute of Land Policy and UCLA School of Law Conference, January, 1982

Figure 1  
TAX AND EXPENDITURE POWERS (JUNE 1, 1982)

States	State-Imposed Limits on Local Governments							
	Overall <sup>1</sup> Property Tax Rate Limit	Specific <sup>1</sup> Property Tax Rate Limit	Property Tax Levy Limit	General Revenue Limit	General Expenditure Limit	Limit on Assessment Increases	Full Disclosure	Limits on on State Governments
Nevada	CMS*			CM**				
New Hampshire								
New Jersey			C**		MS**			Stat.**
New Mexico	CMS*	CMS**	CMS***			CMS**		
New York		CMS*						
North Carolina		CM**						
North Dakota			CMS***					
Ohio	CMS*		CMS**					
Oklahoma	CMS*	CMS*						
Oregon			CMS*			CMS***		Stat.***
Pennsylvania		CMS*						
Rhode Island								Stat.**
South Carolina			3					Stat.***
South Dakota		CMS*						
Tennessee						CMS***		Const.***
Texas		CMS**				CMS***		Const.***
Utah		CMS*						Stat.***
Vermont								
Virginia						CM**		
Washington	CMS**	CMS**	CMS**	S**				Stat.**
West Virginia	CMS*	CMS*						
Wisconsin		CMS*	CM**		S**			
Wyoming		CMS*						

C—County M—Municipal

S—School District

\*—Enacted before 1970

\*\*—1970-77

\*\*\*—1978 and after

Const.—Constitutional

Stat.—Statutory

<sup>1</sup> Overall limits refer to limits on the aggregate tax rate of all local government. Specific rate limits refer to limits on individual types of local governments or limits on narrowly defined services (excluding debt).

<sup>2</sup> Limits follow reassessment.

<sup>3</sup> Limit followed transition to a classified property tax.

Source: ACIR staff calculations.

**more intensive use of service charges in particular?** Raising the rates on existing user charges clearly stands out as the most frequent nonproperty tax action taken—72% of the respondents indicated that this policy was followed by their communities during 1980-81 (see *Table 2* for survey results). Local policymakers seem to be reading the public mind quite accurately. A 1981 ACIR public opinion poll documents the fact that taxpayers prefer user charge financing by overwhelming margins compared to other local tax increases, if local taxes have to be increased.<sup>1</sup> When asked specifically: "Suppose your local governments must raise more revenue, which of these do you think would be the best way to do it?" 55% of the respondents

in September 1981, selected user charges. This percentage was more than 2.5 times that selecting local sales taxes, the second favorite choice. Other revenue choices included local income taxes and property taxes. Indeed, user charge financing was the first choice in each of the individual socio-economic demographic groups surveyed—and by quite substantial margins in each case. Notably, the support for user charges was highest in the northeast where charges and fees are relatively under-utilized.

Greater use of "benefit" taxation was also reflected in responses to the questionnaire. Nearly 26% of the respondents reported action on the special assessment front. As pointed out earlier, local governments in California were quite active in raising development-related fees and exactions to replace lost property taxes. This shift may be viewed as substituting a more narrowly defined benefit tax for a broad-based general tax (the

<sup>1</sup> See ACIR, *Changing Public Attitudes on Governments and Taxes*, S-10, Washington, DC, 1981, p. 38.

property tax). However, special assessments fall short of being a specific user fee because the levy does not vary directly with use an individual makes of the facilities.

**Is there strong opposition to greater use of service charges and if so, why?** Almost half of the respondents indicated no strong community opposition to greater use of service charges. Among those who did indicate opposition, the regressivity of user charges was cited by 17% as an "important" obstacle. Regressivity was deemed "fairly important" by another 17%. Interestingly, the fact that taxpayers cannot deduct local user charges in calculating taxable federal income was cited by only 7% as an important factor working against more intensive use of municipal service charges.

Although a number of respondents did oppose expanding user charges for equity reasons, 60% of the finance officers either were not opposed to user charges or specified that possible hardships on the poor were not an important reason for their opposition to user fees. This strong support for user fees may reflect a belief, at least at the local level, that charging individuals

for the direct benefits of government services (where identifiable) is more equitable than subsidizing their consumption from general revenue sources.

**Do cities display a significant difference in fiscal behavior when classified by the presence or absence of tax and expenditure lids?** The quick answer is no, although some differences exist in the reasons cited for their actions. For example, both tax limitation and nontax limitation cities clearly favored greater use of service charges and behaved about the same in "privatization" areas, i.e., contracting out, and franchising (see Table 3). Cities with TELs, however, were somewhat more active on the special assessment front and more inclined to have developers contribute toward the necessary public services than were their non-TEL counterparts. The greatest increase in developer fees occurred in California.

When citing reasons for their behavior, only California and Massachusetts cities put considerable importance on the presence of tax lid legislation—a not unexpected reaction given that their lids are more restrictive than those imposed on communities in most

Table 2

## INCREASED USE OF NONPROPERTY TAX REVENUE SOURCES AND PRIVATIZATION ACTION, SURVEY CITIES,<sup>1</sup> 1980-81 PERCENT DISTRIBUTION

I. Nonproperty Tax Actions <sup>2</sup>				
	Any Actions	New Adoption	Increased Rate	Extended Base
1. Special assessments	26.3%	8.0%	11.9%	9.6%
2. User charges	77.6	14.8	71.7	4.3
3. Local sales	7.5	2.3	4.1	1.1
4. Local income	4.6	0.5	3.2	0.9
5. Other	5.5	5.0	0.2	0.2
6. No action	15.5	—	—	—
II. Reasons Cited for Action <sup>3</sup>				
1. Expenditure growth	90.8%			
2. Limitation legislation	23.0			
3. Federal aid cuts	30.0			
4. Property tax pressures	39.7			
5. Other	19.7			
III. Privatization Actions				
1. Developer contributions	23.7%			
2. Contracting out	16.9			
3. Franchising	2.7			
IV. Reasons for Opposing User Charges				
	Important	Fairly Important	Not Important	
1. Regressive	17.4%	17.4%	6.4%	
2. Minor revenue	8.7	15.3	13.7	
3. Not deductible	6.8	8.2	22.8	
4. Other	6.6	0.7	1.4	
No opposition cited: 53.9%				

<sup>1</sup> Number of cities responding to questionnaire is 438.

<sup>2</sup> Because cities may take more than one of the specific actions for any tax source, the sum of the specific actions will exceed the total in the "any actions" column.

<sup>3</sup> Refers to greater use of nonproperty tax sources. Percentages do not add to 100 because respondents were not restricted to one choice.

Source: Preliminary data from ACIR-MFOA December 1981 survey.

other states. Expenditure growth (due to inflation), property tax pressures, and federal aid cuts were all cited more often than limit laws as reasons for taking nonproperty tax action.<sup>5</sup>

**Does size of place make a difference in municipal fiscal behavior?** Yes. Large cities—with populations over 250,000—clearly exhibited the greatest willingness to make more intensive use of nonproperty tax sources and to adopt privatization policies.<sup>6</sup> The respondent large cities also cited federal aid cuts and property tax pressures more frequently than did responding small cities as reasons for diversifying their revenue systems.

**Does geography (regional location) cause significant variations in municipal fiscal behavior?** Yes, there appear to be fairly significant regional variations in recent fiscal actions. The Rocky Mountain cities relied most heavily on user fee increases with 90% reporting increases.<sup>7</sup> The southwest and Great Plains cities followed in frequency of user charge increases. Sixty-seven and four-tenths percent of mideast cities reported increases in user fees, the lowest percentage among the regions. There is also a wide range in the use of special assessments—from a low of 15% among southwest cities to a high of 46% for the cities in the Great Plains region.

#### Living Within Fiscal Constraints: The California And Massachusetts Experiences

The sharp increase in user fees and other nonproperty tax revenues is perhaps nowhere more evident than in California and Massachusetts, two states with the most restrictive taxing and spending lids. *Table 4* illustrates the shift in the relative importance of user fees in the revenue structure of large California cities (population greater than 300,000) from FY 1977 to FY 1980.

An upward trend in the relative importance of user fees—when measured as a percentage of local own-source revenue accounted for by charges and fees—is readily apparent during the immediate post-Proposition 13 years. The sharp increases in the relative importance of fees during FY 1979 for most cities reflected a significant increase in user fees, as well as a substantial reduction in local property tax revenues. In San Francisco, for example, user fee revenues increased by more than 27% in FY 1979.

The renewed growth in property tax revenues and the distribution of part of the state surplus to local governments enabled large cities in California to avoid additional increases in their reliance on user fees during FY 1980. However, the state surplus is now exhausted and cities and counties in California face a

<sup>5</sup> For additional details concerning the differences in responses by cities with and without TELs, see John Shannon, "The Tax Revolt and Its Effects on Municipal Revenue Behavior," paper prepared for the Lincoln Institute of Land Policy and UCLA School of Law Conference, January, 1982, table A-3.

<sup>6</sup> *Ibid.*, table A-4.  
<sup>7</sup> *Ibid.*, table A-5.

Table 3

### INCREASED USE OF NONPROPERTY TAX REVENUE SOURCES AND "PRIVATIZATION ACTION," BY SURVEY CITIES, 1980-81— TAX LIMITATION ANALYSIS

Responses	All Cities (438) <sup>1</sup>	All Cities Without TELs (34) <sup>1</sup>	All Cities With TELs (404) <sup>1</sup>
<b>I. Nonproperty Tax Action<sup>2</sup></b>			
1. Special assessments	26.3%	26.5%	26.2%
2. User charges	77.6	73.6	78.0
3. Local sales	7.5	—	8.2
4. Local income	4.6	—	5.0
5. Other	5.5	—	5.9
6. No action	15.5	26.5	14.6
<b>II. Reasons Cited for Action<sup>3</sup></b>			
1. Expenditure growth	90.8	88.0	91.0
2. Limitation legislation	23.0	—	24.6
3. Federal aid cuts	30.0	16.0	31.0
4. Property tax pressures	39.7	40.0	39.7
5. Other	19.7	16.0	20.0
<b>III. Privatization Action</b>			
1. Developer contributions	23.7	17.7	24.3
2. Contracting out	16.9	17.7	16.8
3. Franchising	2.7	—	3.0

<sup>1</sup> Number of cities responding to questionnaire.

<sup>2</sup> Because cities may take more than one of the specific actions for any tax source, the sum of the specific actions will exceed the total in the "any actions" column.

<sup>3</sup> Refers to greater use of nonproperty tax sources. Percentages do not add to 100 because respondents were not restricted to one choice.

Source: Preliminary data from ACIR-MFOA December 1981, survey.

20% reduction in state aid in FY 1983. As a result, municipalities may be due for another upsurge in user fees.<sup>8</sup>

Although statewide data on changes in local government finances in Massachusetts for the first year following Proposition 2½ are not yet available, Concord's experience provides an interesting case study of the diversification strategies available to Massachusetts cities and towns.<sup>9</sup> To cope with lost property tax revenues, Concord established a policy guideline to "reduce tax support for areas able to produce alternative revenues." Town officials identified the water and sewer departments, recreation activities and ambulance services as budget functions that should

<sup>8</sup> As reported in *The New York Times*, July 2, 1982. In fact, preliminary results from a National League of Cities survey of city fiscal conditions in the spring of 1982 indicate that cities are raising existing fees to meet current fiscal problems. Thirty-five out of 43 respondents (81%) reported increasing fees in FY 1982.

<sup>9</sup> See Anthony T. Logalbo, "Responding to Tax Limitation: Finding Alternative Revenues," *Governmental Finance*, March 1982.

Table 4

**RELATIVE IMPORTANCE OF USER FEES IN LARGE CALIFORNIA CITIES SELECTED FISCAL YEARS**

City	Relative Importance <sup>1</sup>			
	1977	1978	1979	1980
Long Beach	30.8%	32.8%	40.5%	36.5%
Los Angeles	17.6	18.9	21.6	21.9
Oakland	28.4	31.2	37.5	34.7
San Diego	15.5	14.6	15.4	16.0
San Francisco	17.9	20.5	29.3	28.2
San Jose	23.1	22.8	24.5	23.3

<sup>1</sup> Current user charges as a percentage of own source local revenues.  
 SOURCE: ACIR staff calculations based on U.S. Department of Commerce, Bureau of the Census, *Local Government Finances in Selected Metropolitan Areas and Large Counties*, various years.

become self-supporting immediately through the adoption of new user charges, as well as increases in existing fees.

The potential pitfalls of spiraling user fees did not escape the attention of Concord's finance director who noted:

Injudicious use of fees and charges can undermine basic public support for the full range of local government activities while permitting the maintenance of services susceptible to pricing. It would be ironic if the move toward user charges resulted ultimately in the withering of services that remained to be financed from taxes.<sup>10</sup>

George Peterson of the Urban Institute also identified this potential problem in a recent analysis of the fiscal effects of tax limitations.<sup>11</sup> According to Peterson, local governments are "unbundling" municipal budgets by earmarking specific revenue sources to finance more narrowly defined public services and activities. Peterson notes that the increased use of dedicated revenue sources could potentially lead to a more fragmented budget process and reduce budget flexibility in local governments. This change may cause activities financed by dedicated revenues or user fees to be freed from expenditure and tax limits, while general public services, including education, public safety, general administration and income redistribution programs, become more tightly constrained.

**Conclusion**

It is becoming increasingly clear that the tax revolt has had two distinct effects on the public sector. The first was the blizzard of fiscal restrictions imposed on

state and local governments during the 1970's. Many students of public finance will be quick to point out, however, that these restrictions were more apparent than real. To put it more directly, most of the legal restrictions have significant loopholes giving state and local policymakers considerable leeway if they choose to exercise it.

The second—and far more important effect—was the "go-slow" message flashed to elected officials throughout the country. It signaled the need for striking a more even balance between private and public sector growth. Instead of growing at a consistently faster rate than that of the private sector, *state-local spending should henceforth either approximate or lag slightly behind the growth in the taxpayers' income.*

The tax revolt has also left its mark on the revenue side of the fiscal equation. As underscored by ACIR's opinion polls, the public now clearly favors greater use of service charges if additional revenue is needed to finance local governments. Many voters may feel that user fee financing will serve as an additional constraint on the growth of specific public expenditures: services will only be expanded if users are willing to pay for the expansions. *The mood of the country can be summed up with a bit of doggerel—*

Don't tax me and don't tax thee.  
 But charge that user a darn good fee.

*Robert J. Cline is ACIR Senior Public Finance Resident. John Shannon is Assistant Director for Taxation and Finance. Two former ACIR staff members, L. Richard Gabler and Robert B. Lucke, assisted in the preparation of this material.*

<sup>10</sup> *Ibid.*, p. 19

<sup>11</sup> George E. Peterson, "The Allocative, Efficiency and Equity Effects of a Shift to User Charges and Benefit-Based Taxes," The Urban Institute, January 1982.

## President Names New ACIR Chairman, State Member

On June 25, President Reagan named Dr. Robert B. Hawkins Chairman of ACIR. Dr. Hawkins, who has served as a private citizen member on the Commission since June 1981, replaces Interior Secretary James G. Watt as chairman. Secretary Watt will remain a commission member representing the Executive Branch.

Dr. Hawkins is currently president of the Sequoia Institute, a nonprofit organization in Sacramento, CA, dedicated to encouraging effective local self-government within our federal system. Dr. Hawkins is ACIR's sixth chairman since its founding in 1959.

Senator David E. Nething, Majority Leader of the North Dakota Senate, was named by the President to serve as one of three state legislators on the Commission. Senator Nething has been active in the National Conference of State Legislatures, most recently serving as chairman of NCSL's State-Federal Assembly and a member of the organization's six-person team negotiating with the White House on the New Federalism proposals. Senator Nething is also on NCSL's executive committee and is a member of the State and Local Coalition, an organization of state and local officials that meets periodically when issues of common concern arise.

## ACIR Adopts Regulatory Reform Agenda

At its summer meeting on July 14, the ACIR urged that federal regulation of state and local governments be "confined to the minimum level consistent with compelling national interests." The Commission recommended that the federal government fully reimburse states and localities for all direct expenses incurred in implementing new federal statutory mandates. In addition, the Commission found that changes are needed to better coordinate the many crosscutting regulations that apply to all or most federal grants. One of the ways the President, executive departments, and independent regu-

latory agencies could ease the regulatory burden on states and localities would be to use alternative, more flexible, regulatory techniques. In lieu of traditional regulations, the Commission suggested that federal officials consider substituting performance standards, special provisions for small units of government, marketable rights, economic incentives, and compliance reforms.

The Commission also adopted recommendations passed by the Committee of the Whole last March. This set of recommendations includes a call for repealing certain relatively new, coercive types of regulations such as "crossover sanctions" where failure to comply with provisions in one law may result in losing federal aid under other specified programs. Partial preemption programs, the Commission found, should be administered on a more cooperative basis. Several major environmental laws employ the partial preemption device whereby minimum federal standards are established but states are allowed to adopt or continue to use standards that are at least as high as national ones. A lack of consultation with state and local officials, ACIR found, was an important part of the difficulties in federal regulation. To correct this problem, the Commission affirmed the right of state and local officials to participate from the beginning in developing federal rules affecting them and urged that all major rules be accompanied by analyses detailing their fiscal and nonfiscal impacts on state and local governments.

## Commission Testifies before Joint Economic Committee, Comments on Pension Legislation

ACIR Assistant Director John Shannon testified before the Joint Economic Committee (JEC) on July 20. The JEC requested the views of ACIR on how the New Federalism proposals will affect the finances of states and localities over the next several years. In Dr. Shannon's view, "There is reason to suspect the federal aid situation will continue to deteriorate." If federal aid does continue

to claim a decreasing share of the federal budget for the next few years, Dr. Shannon anticipates that Congress will be faced with three alternatives: (1) slow withdrawal along the entire categorical aid front; (2) draw in the categorical aid line and consolidate the grants at lower funding levels into block grants; or, (3) negotiate a new federal-state-local agreement. Dr. Shannon pointed out that, although it is difficult to institute major changes in times of stress, "fiscal austerity both prevents federal policymakers from constantly increasing the number and cost of federal aid programs and tends to force them to allocate diminished resources to those programs of greatest national priority."

Dr. Robert Hawkins, ACIR's new chairman, has written to the members of relevant Senate and House committees expressing the Commission's strong opposition to Senate bills 2105 and 2106 and H.R. 4929, all of which would impose federal reporting, disclosure, and fiduciary requirements on state and local retirement systems. In 1979, following an examination of the intergovernmental dimensions of state and local pension issues, the ACIR opposed federal regulation of state and local retirement systems "because such a policy represents unjustified and undesirable intrusion into the fundamental areas of personnel and their compensation." The Commission is, however, on record favoring a firm and aggressive state role in improving state and local retirement programs.

## December Commission Meeting Scheduled

ACIR's next meeting will be held on December 2-3, 1982. At that time, the Commission is slated to consider further several issues basic to the New Federalism proposals. The meeting is scheduled to be held in Room 2154, Rayburn House Office Building, Washington, DC. As is customary, ACIR meetings are open to the press and the public.

Table 1  
**AN INDEX OF THE TAXES OF "LAST RESORT":  
 The Pressure States Place on their Income and Sales Taxes<sup>1</sup>**

State and Region	Index of "Last Resort Taxes" <sup>2</sup>	Increases in Taxes on Individuals from 12/31/80 to 8/1/82*	Index of "Last Resort Taxes" <sup>2</sup>	Increases in Taxes on Individuals from 12/31/80 to 8/1/82*	
<b>U.S. Weighted Average</b>	100	n.a.			
<b>New England</b>			<b>Southeast</b>		
Connecticut	62	—	Alabama	102	
Maine	96	A	Arkansas	98	G
Massachusetts	107	G <sup>3</sup>	Florida	52	S
New Hampshire	3	G.A	Georgia	105	—
Rhode Island	99	C	Kentucky	109	G.A
Vermont	69	G.A.S	Louisiana	101	—
<b>Mideast</b>			Mississippi	126	—
Delaware	93	G	North Carolina	110	G
Maryland	126	G	South Carolina	112	G
New Jersey	67	C	Tennessee	83	G.A
New York	168	—	Virginia	87	G.A
Pennsylvania	102	—	West Virginia	106	A.S
<b>Great Lakes</b>			<b>Southwest</b>		
Illinois	94	—	Arizona	89	G
Indiana	93	G <sup>3</sup> .A	New Mexico	100	G <sup>3</sup> .A <sup>5</sup>
Michigan	99	A.C.I	Oklahoma	75	—
Ohio	80	G <sup>3</sup> .A.C <sup>4</sup> .S.I	Texas	45	—
Wisconsin	130	G.A.C.S	<b>Rocky Mountain</b>		
<b>Plains</b>			Colorado	101	G.A
Iowa	94	G.C	Idaho	92	G
Kansas	80	—	Montana	43	— <sup>6</sup>
Minnesota	111	G.A.C <sup>5</sup> .S.I	Utah	137	G.A.C
Missouri	88	C	Wyoming	73	—
Nebraska	89	G <sup>3</sup> .A.C.S	<b>Far West</b>		
North Dakota	66	— <sup>6</sup>	California	137	G <sup>9</sup>
South Dakota	67	G.A.C	Nevada	32	G.A.S <sup>10</sup>
			Oregon	75	G.C.I
			Washington	66	A.C.S <sup>11</sup>
			Alaska	56	— <sup>12</sup>
			Hawaii	138	—

\*Legend for codes in column four: G - Gasoline and motor fuels; A - Alcohol; C - Cigarettes; S - General Sales; I - Individual Income

<sup>1</sup>The taxes included in these figures are state and local individual income taxes and general sales taxes. (Local income and sales taxes were included since most states determine whether local governments can impose local income or sales taxes and the rates that the local governments can impose.) The index numbers were determined by multiplying the U.S. average tax rates by the respective individual income and general sales tax bases of each state. Adjustments were made to the general sales tax collections in the cases of Arizona, Hawaii, Washington and West Virginia because these states have much broader sales tax bases than the typical state. In addition, individual income tax collections for the state of New York had to be revised downward because the local individual income tax collections included a small portion of corporate income tax receipts.

<sup>2</sup>The greater the index number, the greater the degree of utilization of the underlying tax bases. U.S. Average 100

<sup>3</sup>Variable rate tax based on percentage of price rather than cents per gallon

<sup>4</sup>In actuality Ohio lowered the excise tax on cigarettes from 15c to 14c per pack

but, for the first time, made them subject to the state sales tax. The net effect of this was to raise the tax on cigarettes.

<sup>5</sup>Extended sales tax to cigarettes for the first time

<sup>6</sup>Reduced income tax

<sup>7</sup>An additional 3% excise tax on oil companies doing business in Virginia was enacted.

<sup>8</sup>Reduced the sales and income taxes

<sup>9</sup>California is scheduled to increase its gasoline tax January 1, 1983.

<sup>10</sup>This increase in the sales tax was enacted to reduce local property taxes.

<sup>11</sup>Lowered the variable rate motor fuels tax from 13.5c to 12c, effective through 12/31/82. Also placed a 4% surcharge on all general fund taxes.

<sup>12</sup>Eliminated individual income tax in 1980

Sources: ACIR, *Tax Capacity of the Fifty States* (Supplement, 1980 Estimates June 1982); Commerce Clearing House, *State Tax Reporter* (various state volumes); S. Gold and D. Pilcher, "State Tax Increases: R. for Ailing Budgets?" in *State Legislatures*, July-August, 1982; ACIR staff calculations, September 1, 1982



## Tax Pressure, Tax Increases, And Parity

Although 34 states have increased one or more state taxes during the 1981 and 1982 legislative sessions, it would be premature to hail these actions as conclusive proof that the "tax revolt" is dead and that the big spenders are once again in control of more state legislative bodies. In sharp contrast to the brisk state tax activity prior to Proposition 13, this latest round of tax hikes was not pushed through to expand programs but to enable states to keep most of what they currently have. Specifically, these tax increases were designed to offset part of the revenue losses caused by the recession (and, to a lesser extent, by federal aid cutbacks) that were not or could not be made up by expenditure belt-tightening.

Moreover, the state tax increases followed a clear priority of political acceptability. When confronted with a budget crunch necessitating revenue increases, state legislators first hiked user charges, then motor fuel taxes (26 states), then the "sin" taxes on alcohol and/or cigarettes (24). Only as a last resort, when confronted with a severe revenue shortfall, did states raise their general sales (nine) and individual income taxes (four). In fact, raising individual income and/or general sales taxes in this post-Proposition 13 era stands out as the "acid test" of a state's desperate need to keep its head above the fiscal water.

### Index Of The "Last Resort" Taxes

Because states rely primarily on sales and income taxes to make budget ends meet, we decided to calculate the room for maneuver that cash state has in the "last resort" tax field. The index of "last resort" state taxes was calculated by first applying national average state tax rates to each state's general sales and individual income tax bases to estimate the hypothetical tax capacity for these two taxes. Then, the state's actual sales and income tax collections were divided by these hypothetical average yields to produce the index numbers listed in *Table 1*.

Table 2

### TAX PRESSURE INDEX

	HIGH (>100)	LOW (<100)	ROW TOTALS:
<b>RAISED INCOME AND/OR SALES TAX</b>	3	8	11
<b>DID NOT RAISE INCOME AND/OR SALES TAX</b>	17	22	39
<b>Column totals</b>	20	30	50

Source: ACIR staff calculations.

New Hampshire, with the lowest tax pressure reading (3), has the greatest amount of elbow room in this critical "taxes of last resort" category. Conversely, New York, with the highest tax pressure reading (168), theoretically possesses the least amount of latitude for general sales or personal income tax increases.

*Table 1* illustrates not only the theoretical ability of states to tap these "taxes of last resort" but also their actual willingness to raise them (or other lesser taxes) since the beginning of 1981. Of the 11 states that raised either general sales or income taxes (or both), only three of them can be counted as high tax pressure states—Wisconsin, Minnesota and West Virginia, all with indices over 100 on the Index of "Last Resort" Taxes. In striking contrast, several relatively low tax pressure states—Alaska (56), Montana (43) and North Dakota (66)—not only did not raise any of these taxes but were able to lower or repeal the state income tax.

As might be expected, the states hardest hit by economic recession show the greatest amount of state tax increase action—the Great Lakes states, several of the Plains states and Washington and Oregon in the Far West region. Most of the states in the other regions were able to avoid increasing the most unpopular taxes—the general sales and individual income taxes.

Without exception, those states forced to raise their general sales tax or individual income taxes also took action on the business tax front—usually by decoupling the state corporate income tax from the accelerated cost recovery provisions of the federal income tax code.

In effect, this tax index attempts to provide a current reading of relative state tax pressure by first presenting the 1980 tax pressure index numbers based on the latest available statistical data, and then by updating these estimates in the best way that we can—by listing tax increases legislated since 1980. Thus policymakers in Ohio, for example, can take grim satisfaction in the fact that their state appears to still be in a relatively better tax pressure position (after raising its gasoline, cigarette, alcohol, general sales and individual income taxes) than the high pressure states of Minnesota and Wisconsin that had to take similar action.

Another grim note emerges—there appears to be a definite movement toward greater tax pressure parity (see *Table 2*). Only three of the 20 high pressure states (15%) increased their individual income and/or general sales taxes while eight of the 30 low pressure states (27%) did so.

Michael W. Lawson  
John Shannon

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