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Major Fiscal Trends in the 1980s and Implications for the 1990s

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Abstract

Among the major fiscal trends and events of the 1980s reviewed in this paper are: continued government sector growth in the economy; changes in the structure of the US federal system, both qualitative and quantitative; declining rates of public sector investment; declining rates of federal grants-in-aid; the tax revolt movement and its effects on state-local finances; the effects of the Tax Reform Act of 1986 on municipal bond markets and on state-local tax systems; the effects of inflation on state-local revenue systems; changes in the structure of state-local revenue systems; and intensified intergovernmental tax and expenditure competition. These and other developments during the past decade set the stage for a lively and difficult new decade for intergovernmental fiscal relations in this country.

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Major Fiscal Trends in the 1980s and Implications for the 1990s

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We live in exciting times for students of federal systems of government. In Canada, the USSR and elsewhere momentous changes are in the offing. Things are quieter in the US but still carry their fair share of challenge and conflict. In this paper I should like to review the intergovernmental fiscal trends and events of the past decade and to speculate about their implications for the policy options of the next ten years. The problems are numerous and substantial, but economists are encouraged by an impressive flow of high-quality research, which should be helpful to policymakers.

Government Spending in the 1980s

During the 1980s the government sector grew somewhat more rapidly than did the economy as a whole. That change is clear in the two standard measures of government size -- the public sector's share of Gross National Product (GNP), which rose from 19% in 1979 to 20% in 1989; and total government expenditures as measured in the national income accounts, which rose from 31% of GNP in 1979 to 34% in 1989 (Table 1). The same change probably occurred in the more comprehensive, but harder to quantify, measures of government importance which would include contingent liabilities such as guaranteed government loans, tax expenditures, and the hidden costs of regulatory programs.

Changes in the structure of the public sector were more dramatic. As Martha Derthick put it near the end of the decade: "it is a commonplace of contemporary comment that the states are

TABLE 1

Government Expenditure-to-GNP Ratios, Selected Years

1949-89

Year	Purchases of Goods & Services			Own-Financed Expenditures	
	Total	Federal	State-Local	Federal	State-Local
1949	15.0%	8.1%	6.9%	16%	7%
1959	19.7	11.0	8.7	19	8
1969	21.5	10.4	11.1	20	10.5
1979	18.7	7.1	11.6	21	10
1989	19.8	7.7	12.1	23	11

Sources: *Economic Report of the President* (Feb.1990, pp. 389-90; *Survey of Current Business* (April 1990), p.16.

TABLE 2

Federal-State-Local Expenditure Shares, Selected Measures

1978 and 1988

Measure		Percentage Shares*		
		Federal	State	Local
Purchases of goods & services:	1978	38.1	19.7	42.2
(government output)	1988	39.4	21.3	39.3
Nondefense government output:	1978	16.7	26.5	56.7
	1988	12.4	30.8	56.8
Total direct expenditures:	1978	56.6	16.3	27.1
	1988	60.6	15.8	23.6
Own-financed expenditures:	1978	67.7	18.5	13.7
	1988	67.3	18.7	14.0

*Percentage shares may not add to 100 because of errors of rounding.

Sources: *Survey of Current Business* (May 1986), pp. 27,29, and (Oct. 1989), p. 24.

enjoying a renaissance" (Derthick, 1989, p.34). Both the qualitative and the quantitative dimensions of that renaissance are matters of some dispute. Are we entering a new age of *cooperative* federalism in which federal and state-local governments bargain on a more or less equal basis on policy issues of mutual interest, or are we instead beginning a new phase of *cooptive* federalism, in which state sovereignty will be steadily eroded by the coersive features of federal regulatory and environmental policies and by the eroding effects of federal tax laws on state and local revenue-raising powers? (Timothy Conlon, 1988). Or is the new phase, perhaps, a two-way *intrusive* federalism, in which each level of government becomes increasingly involved in what have long been regarded as sole, or at least primary, concerns of the other? Especially notable, as the Advisory Commission on Intergovernmental Relations has recently documented, have been the growing activities of state and local governments in international affairs -- and especially in world commerce (ACIR, 1990a).

When one looks at the quantitative dimensions of those structural changes, the picture is also hard to interpret. What you see depends on where you look, and where you look depends on your purpose in looking. The variety of measures offers many choices, but the main ones, summarized in Table 2, show the following changes in federal-state-local expenditure shares between 1978 and 1988:

The federal share of total expenditures on goods and services -- i.e., total government output -- rose from 38% to 39%; the state share also rose (from 20% to 21%); and the local share

fell from 42% to 39%.

The federal share of nondefense government output fell significantly; the state share rose correspondingly; and the local share was unchanged.

When transfer payments and subsidies are added to output expenditures, the federal share of total direct expenditures rose significantly, the local share fell significantly, and the state share fell slightly.

When attention is focused on own-financed expenditures, which include grants made in aid of other governments and exclude grants received from others, only slight changes are observed, the federal share falling and the other two rising.

The sharply differing trends exhibited by direct and own-financed expenditures reflect, of course, one of the big fiscal stories of the 1980s -- namely, the decline in federal grants-in-aid to state and local governments. From their peak in fiscal 1978, when they were over 26% of state-local outlays, 17% of federal outlays, and 3.6% of GNP, federal grants had fallen by fiscal year 1988-89 to 18% of state-local expenditures, under 11% of federal spending and 2.4% of GNP (ACIR, 1990b, p.42). Budgetary projections for fiscal years 1991-95 show federal grants rising slightly faster than total federal outlays but more slowly than GNP (Congressional Budget Office, 1990). The declining trends of the 1980s, which helped to reinvigorate state and local government abilities to deal with fiscal adversities in John Shannon's famous _fend-for-yourself_ federal system, may well be at an end. The enhanced resourcefulness of state and local governments will stand them in good stead in the 1990s, when they

may well face the much more important constraints imposed by low rates of economic growth. More important, in a new environment of stability attention can be shifted from the selection of programs to cut to ways of improving the effectiveness of a steady flow of intergovernmental aid. This is likely to be one of the important fiscal policy issues of the 1990s and will be discussed later in the paper.

State-Local Revenue Systems

The state-local sector, then, begins in the 1990s with greater responsiblities both for the provision of domestic public services and for the financing of those services from its own resources. Unfortunately, it also begins the decade in a considerably weaker fiscal position tha it enjoyed during most of the 1980s. Operating budget balances, as measured in the National Income and Product Accounts (NIPA), after showing surpluses in the four-year period 1983-86, shifted to deficits in 1987 which increased from $8 billion in that year to an estimated $20 billion in 1989. These impersonal averages, as you all know, conceal many dramatic stories of painful state expenditure cutbacks, big city crises, county bankruptcies, and other hardships.

Given these past and present trends it is not a particularly bold forecast to predict that the adequacy, efficiency, and equity of state and local revenue systems will be more important and more difficult policy issues in the 90s than in the past decade. Since state and local revenues currently rise at about the same rate as national incomes, absent any of the major tax

reforms to be discussed later, adequacy requires a strongly growing economy with relatively low inflation rates. Here the prospects are not very encouraging. Calculations by Keith Carlson indicate that achieving the 1948-89 trend growth rate in real GNP per capita would require an average rate of growth in the nation's capital stock that would be well above past trend rates.[1] A more plausible goal would be a capital stock rising at its 1948-89 trend rate which would yield an estimated long-term average growth rate in per-capita real GNP of 1.5% (Carlson, 1990, p.15). Given the Census Bureau's middle-series population growth projection of 0.7% for the 1990s, real GNP would be growing at about 2.25% a year, well within Alan Garner's range of potential real output growth rates for 1990-94 of 2-3% a year (Garner 1989).

Public Sector Investment

Achieving that potential is a goal to which state and local governments can make important, indeed essential, contributions. The much-discussed task of raising the quality of public education will undoubtedly require the close cooperation of all levels of government, and hence is likely to involve some of the most important intergovernmental fiscal issues of the 1990s. Less conspicuous, but becoming more visible because of recent economic research are the effects on economic growth of public sector investment. In relation to GNP, infrastructure spending by state and local governments fell from a peak above 2.3% in 1970 to 1.75% in 1980 and then to a low of 1.5% in 1983, after which it rose to about 1.6% in 1987 (Fox and Smith, 1990). Of

more significance for growth policy the public sector capital-to-labor ratio after rising until 1973 fell at a 0.5% average annual rate in the 1973-79 period and at a 0.4% average annual rate during the years 1979-87 (Munnell, 1990). As David Aschauer has emphasized in a series of staff memoranda and working papers at the Federal Reserve Bank of Chicago, raising the level of public investment back toward earlier levels would provide a major stimulus to the nation's economic growth (Aschauer, 1988, 1989). Estimates of the size of that stimulus, made recently by Alicia Munnell (1990), indicate that while continuation of the 1980s trend of falling public capital-labor ratios might allow a labor productivity growth rate of 1.2-1.3% a year, higher investment levels that would move the public capital-labor ratio up by two percentage points a year -- about the postwar average growth rate of the private capital-labor ratio -- could well raise the labor productivity growth rate to 2.1% a year.

Given that higher levels of public sector investment are an important national goal for the 1990s, what intergovernmental policy issues are likely to be involved in this endeavor? The first, and most basic, concerns the allocation of operational and financial responsibilities in this area among the different levels of government. In its review of the final report of the National Council on Public Works Improvement, established by Congress in 1984, the Congressional Budget Office noted that "in the last three decades, the federal government has greatly expanded its role in providing public works infrastructure" (CBO, 1988, p.xi). In 1988 federal outlays were $26.6 billion, divided

51% for highways, 20% for aviation, 13% for mass transit, 11% for wastewater treatment, and 4% for water transportation. The extent to which these, and future, allocations reasonably reflect the strength of the national interest in the different infrastructure areas is likely to be an important policy issue in the 1990s.

A second set of policy issues concerns the optimal structure of the federal involvement in public sector investments with significant nationwide benefits. Especially relevant here are the findings of a number of recent research studies of federal grants-in-aid programs. In an interesting analysis of Section 9 formula grants for bus lines, for example, the winner of the 1989 NTA-TIA dissertation prize, Brian Cromwell (1989,1990),found that these capital grants lowered maintenance levels and raised scrappage rates in public transit systems relative to economically efficient management. Though Cromwell estimated the resulting distortion costs to be small, the effects indicated are disturbing, especially in the light of Michael Pagano's arguments that inadequate maintenance spending is a more important cause of infrastructure decay than inadequate capital investment (Pagano, 1989). Whatever the relative importance of these two kinds of government spending, Cromwell's study does show that local governments are sensitive to grant-in-aid price incentives, and federal aid programs can be designed to take advantage of such behavior.

A third, and perhaps less conspicuous, set of intergovernmental policy issues here concerns the effects of federal tax reforms on municipal bond markets. Changes made

in the 1980s, and especially in the Tax Reform Act of 1986 (TRA 86), have reduced the size of the federal subsidy to state and local borrowing but improved the relative allocation of benefits to those governments rather than to high-income investors. Recent economic research by James Poterba (1986) and Gilbert Metcalf (1990) has established the sensitivity of both the demand for, and the supply of, municipal debt to the yield spread between taxable and non-taxable bonds of comparable risk and to future expected income tax rates. TRA 86 made some major changes in municipal bond markets, increasing the importance of individual investors and reducing the role of commercial banks (Poterba, 1989), and hence the level of federal income tax rates in the 1990s is likely to have an important influence on the operation of municipal bond markets and indirectly on the level and structure of state and local infrastructure spending.

Revenue Adequacy and Inflation

Revenue adequacy in a low-inflation economy is one thing, but significant inflation makes it quite another matter. In general, budgetary tensions would be minimized by a revenue system whose responsiveness to inflation closely matched the inflation elasticity of that government's expenditures. In assessing the prospects for future budgetary crises it is not enough just to project nominal spending levels for all automatically inflation-indexed spending programs. Discretionary expenditures may in many cases be as effectively indexed as are programs with legally required upward spending adjustments whenever some general price index number increases. In their

recent analysis of state and local budgetary behavior in the 1972-88 period, Roy Bahl and Jorge Martinez-Vazquez (1990) identified two important reaction parameters. One was an elastic response of per capital real state and local expenditures to any inflation-induced increase in the relative price of state and local public services,[2] and the other was a negative short-run relation between those expenditures and the net liability position of the state-local sector. This suggests that state and local governments would in general experience strong upward spending pressures in an inflationary economy, but that adjustments to those pressures would be delayed by heavily-indebted governments.

On the revenue side one of the most important developments in the 1980s was the structural indexation of the individual income tax whereby personal exemptions, standard deductions, and tax rate brackets were programmed to increase in relation to some general price index number. As Deputy Assistant Secretary of the Treasury Michael J. Graetz (1990) recently put it, the indexing provisions of the Economic Recovery Tax Act of 1981 were "the most significant piece of tax legislation enacted during the 1980s" (p. 1424). By eliminating politically attractive inflation-induced revenue dividends that were typically not fully returned to the taxpayers, indexation contributed importantly to recurring, divisive revenue shortfalls and indirectly, no doubt, to the declining trend in federal grants-in-aid.

Structural indexation of the income tax, of course, is another instance of state fiscal pioneering. By 1980 five states

-- Arizona, California, Colorado, Minnesota, and Wisconsin -- had indexation provisions in operation, but as Daniel Feenberg and Harvey Rosen have carefully documented (1988), of the ten states adopting some form of structural indexation prior to 1985, seven have subsequently suspended their laws for one or more years. Such reneging on fiscal promises is not the most image-enhancing behavior for state governments to engage in. Yet they are not alone in this regard. As Joseph A. Pechman (1988) noted in his survey of tax reform in eleven developed countries, most adopted structural indexation in the 1970s, and most subsequently eliminated or deferred it. Whether the federal government will succumb to similar temptations is one of those intriguing questions to which the 1990s may provide an answer.

Federal Grants-in-Aid

A third important determinant of revenue adequacy for state and local governments in the 1990s will be the behavior and structure of federal grants-in-aid. As noted earlier, stability seems to have replaced the painfully declining trend of the 1980s. At best, it could provide a welcome opportunity for a serious re-examination of the role that intergovernmental grants can, and should, play in an economic world increasingly affected by strong worldwide competitive forces. This important undertaking has already begun. In a pioneering study Robert Inman (1988) carefully related the federal grant system to the standard normative economic tests of equity and efficiency and found it sadly lacking in economic rationale. The specifics of that discouraging -- at least to economists -- assessment are as follows:

Normative function of federal grants

A. Efficiency

1. To induce state and local governments to provide appropriately high levels of national public goods.

Inman's conclusion: "On balance, the national purpose arguments do not support the observed structure of federal assistance" (p.49).

2. To encourage state and local governments to provide efficient levels of non-national public goods with significant levels of positive or negative spillovers.

Inman: "On balance, the spillover rationale...does little to help us understand the actual distribution of federal aid" (p.49).

3. To offset state or local governmental failures to provide public good offerings that achieve within-community allocative efficiency.

Inman: "The evidence is weak at best..." (p. 51).

B. Equity

4. To achieve a more equitable distribution of especially meritorious non-national public goods, such as education.

Inman: "While federal aid is a useful step toward state-local fiscal equity,...it would be hard to rationalize the present aid system as a grant structure designed solely to promote fairness" (p. 54).

One of the major difficulties with the normative economic case for intergovernmental grants concerns the intangible, difficult-to-measure dimensions of the three efficiency

rationales. National purpose, for example, may simply be a hard-to-refute argument for the adoption of programs primarily benefiting some well-organized special interest group. The ultimate efficiency test, of course, involves the effects, positive or negative, of different grant programs on the performance of the US economy. The economic environment is very different now from what it was a decade ago, and the pace of change may well have accelerated. Under such circumstances it would not be at all surprising if the US grant-in-aid system has become a little outdated. It is time for a systematic review of its potential accomplishments. A good framework with which to begin, as Alice Rivlin (1990a) has suggested, would be one that distinguished those programs for which nationwide uniformity is of high importance for economic growth from those "in which diversity and experimentation are desirable, and in which citizen participation and visible accountability are important" (p. 15). The former would then have a major, or perhaps sole, federal input, and the latter would be operated mainly by state and local governments, perhaps with the help of supportive federal grants.

In the presence of the budgetary stringencies likely to haunt many governmental units during at least the early part of the 90s the effectiveness of intergovernmental grants as a fiscal instrument becomes a critical policy issue. Perhaps one of the most helpful developments of the 1980s has been the application of state-of-the-art economic and econometric research to the problem. Only a few of the most promising examples can be mentioned here. The first concerns the long-standing mystery

surrounding block grants. Do they really stimulate grantee spending as much as many studies seem to show they do, and if so, why are they behaving so contrary to the predictions of the standard economic models? That mystery may at long last be in the process of unravelling. Using a computable general equilibrium model of an open local economy Daniel Hewitt and Dennis Heffley (1989) show that block grants can have surprisingly large effects on local government spending in a rational, utility-maximizing federal economy. This does not mean, as the authors emphasize, that the so-called flypaper effects attributable to voter fiscal illusions or self-seeking bureaucratic power plays do not exist, but it makes at least one economist more confident of the incentive effects of block grants.

A second efficiency question concerns the indirect, offsetting effects that may blunt the stimulating powers of intergovernmental grants. Here, too, recent research provides some encouraging results. In an analysis of 70 major central cities in 1982 John Yinger and Helen Ladd (1989) found no evidence that state aid to cities was inversely related to the level of federal aid, and in her time series study of state aid programs in 44 states from 1982 to 1987 Ladd (1990) also found no state offsets to changes in direct federal-to-local aid for education and public welfare. For other direct aid progams, however, the offset appeared to be larger than 80 cents for each $1 change in federal grants.

As redistributive fiscal instruments intergovernmental grants operated with at least a modest degree of success during

the 1980s. The Yinger-Ladd study (1989, p. 424) found, for example, that state grants and institutional assistance, such as the allocating of revenue raising powers to local governments, are regarded by state policymakers as alternative ways of helping fiscally distressed cities, and that together these two policies offset more than 40% of the differences in fiscal condition across cities. In that partnership, however, state grants were very much the junior partner, and federal grants, other than those providing welfare aid, were estimated by Inman to have "had only a marginal effect on the final distribution of state-local public goods" (1988, p. 68).

Several trends of the 1980s suggest that the redistributive features of intergovernmental grants may be a more important policy issue than in the past. One is that, as Daniel Garnick has documented, "after 5 decades of narrowing, regional differences in per capita personal income as a percent of the national average widened in the 1980s" (1990, p. 29). Another, as Joseph Pechman noted in his 1989 Presidential Address to the AEA on the future of the income tax, is that "after several decades of relative stability, the U.S. pre-tax income distribution has become much more unequal in the last ten years" (1990, p. 2). Underlying these broad averages are the much more visible and dramtic pockets of poverty both in rural areas and in the nation's big cities (Ladd and Yinger, 1989). Finally, increasing national concerns about the low quality of public education and the high cost of medical services both focus close attention on ways in which governmental aid programs can improve low-income

families' access to these basic goods and services. In such an environment redistributive governmental grants are a fiscal instrument of prime importance.

State-Local Revenue Systems: Efficiency and Equity

While increases in the fiscal adequacy of state and local revenue systems would make life easier for politicians and policy makers, improvements in the efficiency rating of those systems would contribute more directly, and perhaps significantly, to the performance of the U.S. economy. Like federal grants, state and local revenue systems do not fare well when tested against standard normative economic standards. As discussed at length at a 1982 International Seminar in Public Finance (Charles McLure, editor, 1983), those general guidelines for the assignment of revenue instruments to different levels of government include:

a. Progressive, redistributional taxes should be assigned primarily to the national government.

b. Personal ability-based taxes should be levied only by jurisdictions capable of operating a tax on a global base.

c. Lower-level governments should not use taxes on highly mobile bases.

d. Tax bases distributed highly unequally among subjurisdictions should be assigned to the central government.

e. Benefit taxes and user charges are appropriate at all levels but seem especially suited to local governments, where tax burdens can most easily be matched with benefits received.

Applied to specific taxes these general guidelines suggest the following rules for the design of efficient state-local

revenue systems:

1. Individual income tax bases should be highly correlated with the base used by the central government, the level best able to define it on a global basis, and rate structures should be proportional or mildly progressive.

2. Corporation income taxes should not be used at the state-local level, or if used, should be applied at uniform rates to a similarly defined base allocated to jurisdictions of source in a uniform way (Peggy Musgrave, 1987).

3. Because of high consumer mobilities retail sales taxes are more appropriate at the state than at the local level.

4. Property and payroll taxes are preferred for local governments. A land tax is often rated high because of the immobility of its base. Land values, however, are not at all immobile, falling in areas losing business and workers and rising in boom areas. Moreover, as Helen Ladd and Katharine Bradbury (1988) have recently shown, there is a signficant negative correlation between a city's property tax rate and its property tax base.

Given this framework for the design of efficient and equitable subnational revenue systems, were the major trends and events of the 1980s favorable or unfavorable, and what do these developments portend for the 1990s? Let us consider each of the five main sources of state-local government revenue.

1. <u>Individual Income Taxes</u>

Measured on a national income and product basis, personal income taxes rose from 1.4% of GNP in 1978 to 1.7% in 1988 at the state level and remained stable at 0.15% of GNP at

TABLE 3

State-Local Revenue Systems, 1978 and 1988

Revenue Source		Revenue as % of GNP		Source as % of Total Own-Source General Revenue	
		1978	1988	1978	1988
Personal Income Tax:					
	State	1.40	1.67	21.5	23.7
	Local	0.15	0.15	3.7	3.8
Corporate Profits Tax Accruals:	State	0.51	0.50	7.7	7.1
	Local	0.03	0.04	0.6	0.9
Sales Taxes:	State	2.70	2.73	43.0	38.5
	Local	0.45	0.56	8.4	9.6
Property Taxes:	Local	2.75	2.59	57.9	46.9
Charges and Miscellaneous:	State	0.99	1.52	16.5	21.9
	Local	1.35	2.04	27.4	36.7
Own-Source General Revenue:	State	6.03	6.93		
	Local	4.92	5.56		

Sources: Survey of Current Business (May 1986), pp. 27, 29, and (Oct. 1989), p.24; ACIR, Significant Features of Fiscal Federalism (1990), Vol. 2, Tables 53 and 55.

the local level. As a percentage of own-source revenue, individual income taxes increased from 21.5 to 23.7 during the same period at the state level and from 3.7 to 3.8 at the local level (Table 3). Progressive rate structures of varying degrees of intensity dominated the picture throughout the period. In 1990 32 states and the District of Columbia applied their own progressive rate structures to a broadly defined income base, two (Rhode Island and Vermont) used the federal rate structure, and one (Connecticut) applied progressive rates to nonwage income. At least 36 jurisdictions out of the 44 levying an individual income tax, then, may be said to use ability-based, redistributive income taxes[3] which, as I have argued elsewhere, should in principle be deductible from the federal individual income tax base (Break, 1980, 1985, 1986). In my view, admittedly a minority one in the profession, proposals to restrict income tax deductibility for high-income taxpayers are theoretically backwards. If any part of those taxes should not be deductible it is the non-redistributive portion -- namely, the tax paid at the bottom rate. In any case, it seems reasonably safe to predict that the federal deductibility of state and local taxes will continue to be an important federalism issue in the 1990s. Other issues likely to be prominent on the policy agenda are:

the adoption of a broad-based personal income tax by states now lacking one, thus breaking the stability of the 1980s;

an improvement in the degree of tax base uniformity across states, by greater conformity either to the federal base or to

some other agreed-upon measure of individual abilities to pay;

a rationalization of state tax rate structures, either making them more redistributive by extending tax rate progression into higher levels of personal income, or moving them closer to benefit-model, non-deductible flat-rate levies.

How much progress is made on these issues remains to be seen, but they certainly will provide a forum for lively debate.

2. Corporation Income Taxes

Corporate profits tax accruals, as measured in the national income accounts, fell slightly from 0.52% of GNP in 1978-80 to 0.47% in 1989 for the state-local sector as a whole, and as a percentage of own-source revenues they fell from 7.7 in 1978 to 7.1 in 1988 at the state level while rising from 0.6 to 0.9 at the local level (Table 3). No dramatic changes here, but the tax is an integral part of one of the most fascinating intergovernmental stories of past decades and is certain to continue in that role in the 90s. I refer, of course, to interjurisdictional tax competition, a high-stakes game that has been alive and well during the 1980s and likely, for two main reasons, to intensify in the 1990s. One of these reasons is that technological developments are making many businesses more mobile. The other is the increasingly competitive global market environment in which state and local governments will be operating.

There are at least three conflicting views about the effects of interstate tax competition. One sees it as a negative-sum game in which the players, by trying to improve their positions at the expense of others, all end up worse off than if they had never begun to play. Others view tax competition as a helpful

antidote to bad state and local tax policies. According to this view excessively high and diverse state corporation income taxes are adopted, in spite of their serious economic distortions, because of their strong political appeal and then are moderated to bearable levels by interstate competition. Perhaps the most attractive, as well as most convincing, view is John Shannon's (1989) treatment of tax competition as a valuable fiscal brake. Shannon emphasizes, quite correctly, that looking at tax competition alone is too narrow a focus. Vigorous expenditure, or public service, competition also exists, and, indeed, as he notes, the steady postwar growth in the ratio of state-local, own-source, revenue to GNP suggests strongly that the fiscal accelerator provided by public service competition has been more powerful than the fiscal brake of tax competition.

More direct empirical evidence of the strength of expenditure competition is provided by Case, Hines and Rosen's (1989) well-designed study of state government behavior during the 1970-85 period. The preferred specification of their theoretical model indicated that, other things equal. the impact effects of a dollar of higher spending by a state's neighbors increases its own spending by more than 70 cents. Taken together, Shannon sees intergovernmental tax and expenditure competition as the two "unseen hands" that regulate the state-local system in a generally helpful way.

Like Adam Smith's more famous hidden hand, however, intergovernmental fiscal competition, though necessary for economic efficiency in a federal system, is not likely to be

sufficient. New spending or regulatory initiatives by pacesetting states may not take due account of the effect of negative spillovers on the rest of the country. Because of the uncertainties involved, environmental policy is likely to present policymakers with some particularly difficult intergovernmental issues in the 1990s (Schwab, 1988; Kneese, 1990).

The poorest jurisdictions may need help from higher levels of government in order to provide adequate levels of public services to their residents at reasonable tax burden levels. ACIR's well-established Representative Tax System measures of fiscal capacity and effort, covering the period since 1975 and soon to be extended to a Representative Expenditure System, have provided a valuable tool in the analysis of existing grant-in-aid programs and will offer a helpful framework if grant reform becomes an important policy priority in the 1990s (ACIR, 1990d).

Tax and other fiscal incentives to attract business to particular jurisdictions may not be cost effective, or worse yet may be seriously distorting unless they are carefully targeted to receptive enterprises. This is one of the important policy guidelines resulting from a series of empirical studies carried out during the 1980s by James and Leslie Papke (1984) using an innovative data-rich model that provides simulations of the net-of-tax rates of return on new investments in different industries in different locations in the country. Leslie Papke's research on the effects of state and local tax burdens on the location of new firms and new business investment undertakings and on the size of Gross State Product in manufacturing establishes clearly that the effects are significantly negative but that they are

highly variable across industries and often small in magnitude (Papke, 1987 and 1989 abc). Given the many difficulties involved in designing effective locational incentives for specific kinds of businesses, states in the 1990s might be well advised to focus on their general economic environments, in which an efficient and equitable state-local revenue system is an important ingredient.

Finally, the difficulties created by multijurisdictional businesses for tax authorities at all levels of government trying to operate traditional source-oriented systems of business income taxation, should be emphasized. Neither formula allocation of the profits of a unitary business nor allocation by separate accounting have worked very well in the past (McLure, 1984), and new information gathering and distributing technologies appear to be making the problems more difficult (Multistate Tax Commission, 1990). It may well be time for a radical change in our federal fiscal system. Alice Rivlin's (1990bc) proposal that the present state-local business income tax system be replaced with a national value-added tax shared on the basis of population with the states is worth serious consideration in this regard. At the very least it is time for increased coordination and cooperation on the part of all taxing authorities. The Multistate Tax Commission is to be applauded for initiating its new 4-to-5-year public-private partnership project "to update interstate tax practices and to develop joint services to improve tax administration" (MTC, 1990, p.8).

3. Sales Taxes

Measured on a national income basis, state sales taxes

kept pace with national economic growth between 1978 and 1988, being at 2.7% of GNP in both years, while local sales taxes grew slightly more rapidly (Table 3). Between the same two years sales taxes fell as a percent of own-source general revenues at the state level, but rose at the local level (Table 3).

The 1980s, then, were a period of respectable, but undramatic, quantitative growth. Whether the qualitative, structural changes in state retail sales taxes during the decade were favorable or unfavorable -- i.e. moved the taxes closer to, or farther away from, the normative economic model of a broad-based, low-rate tax on total consumer spending -- is very much an open question. Whatever these past trends may have been, at the beginning of the new decade there appear to be ample opportunities for productive and salable sales tax reform. By salable I mean structural improvement plans that promise to make most people winners. Consider both the opportunities to be grasped from improvements and the risks to be run in defusing the developing tensions that threaten the effectiveness of state and local revenue systems in the 90s.

The great opportunities arise from the continued growth of the kinds of consumption that retail sales taxes typically reach very imperfectly -- namely, services. Between 1979 and early 1990 consumer services, as measured in the national income accounts, rose from nearly 47% of total Personal Consumption Expenditures to over 54%. Broadening the tax base to include many of these items would improve both economic efficiency and interpersonal equity, and if it could be done at acceptable compliance and administrative costs, it might well provide

adequate state-local sales tax revenues at current, or even lower, tax rates.

The tensions facing policymakers in the 1990s are likely to arise from two main sources --first, distinguishing between sales to businesses, which should not be part of a retail sales tax base, and sales to consumers, which should; and, second, reaching interstate sales transactions in a fair and effective way. It has long been known that retail sales taxes include both producers' and consumers' goods in their bases, but reliable quantitative evidence on the relative importance of those two components has been scarce. That gap has recently been narrowed by Raymond Ring (1989), whose estimates for 1979 show the direct consumers' share of the sales tax base to range from 82% in Massachusetts to a low of 35% in Louisiana, with a national average of 59%. These measures exclude the indirect consumer tax burdens resulting from the taxation of producers' goods -- burdens that are desirable if they fall on consumers of items such as housing services that are typically excluded from sales tax bases, but undesirable if they augment burdens on items included in the tax base, and questionable if they fall on out-of-state consumers. Just as the sales tax treatment of producers' goods has been a difficult policy issue in the past, the treatment of business-to-business services will present similar, or worse, problems to states wishing to broaden the scope of their retail sales taxes (Quick and McKee, 1988). Florida has already provided a dramatic example of what can go wrong in such endeavors (Hellerstein, 1988).

Another policy issue of long-standing, and probably intensifying, difficulty is the tax treatment of interstate sales. Can they be included in the tax base at acceptable compliance and administrative costs, and if so how should the revenues be divided between states of origin and states of destination? A number of recent developments are of interest here:

California's move to apply its use tax to consumer goods brought home from abroad by California residents;

Maine's addition of use tax payment checks to its individual income tax returns; and

disputes between states over the right to tax interstate sales, such as Arkansas and Tennessee concerning automobiles, that threaten overtaxation of these transations (Douglas, 1990).

This short sampling of developments during the past decade indicates clearly that sales taxes will be high on the agenda of fiscal policymakers in the 1990s. This, too, is an area in which intergovernmental cooperation and coordination, both horizontally and vertically, will be an important contributor to success.

4. Local Property Taxes

The 1980s began with some ominous years for the local property tax. The first real effects of Proposition 13 in California were beginning to be felt -- initially it served mainly to distribute a large state revenue surplus to local governments -- and Proposition 2 1/2 was passed in Massachusetts. These shocks helped reduce property tax revenues from over 3% of GNP in 1977 to a low of 2.57% in 1980-81. Though revenues recovered to nearly 2.7% of GNP by 1988, the nationwide average

property tax rate in the 1980s was well below its levels in the three preceding decades (Manvel, 1990). As a percent of local government own-source revenues property taxes fell from 58 in 1978 to 47 in 1988 (Table 3).

Threats to the vigor of property tax growth rates at the beginning of the 1990s may not be as dramatic as they were ten years earlier, but they are far from disappearing from the intergovernmental fiscal scene. Both the equity and the efficiency aspects of alternative school finance systems are likely to remain high on the policy agenda for some time to come. The great importance of improving the quality of the nation's school services seems to be matched by the difficulties involved in doing so. To oversimplify a complex situation, parental choice and local control, widely thought to be important inputs in the educational production process, are hard to reconcile with wide, and probably growing, financial disparaties among families and among local governments. As William Fischel (1989) has vividly indicated, the experience with these troublesome issues in California, where it all began in 1971 with the California Supreme Court's Serrano v. Priest (96 Cal. Rptr. 601) decision, is not reassuring. Local school district spending has indeed been greatly equalized, but the local property tax has been considerably reduced both in importance and in its appeal to many voters (Break, 1990), and interdistrict disparaties in student achievement test results appear not to have fallen.

A second threat to the vitality of the local property tax comes from the enhanced level of inter-governmental fiscal

competition, already discussed. Both business and household property tax burdens, then, may be driven down toward the costs of providing the standard set of local government services -- fire, police, streets, and so forth -- to those groups. If this happens, the property tax will be shifted away from the ability model to the benefit model of taxation, and the case for the continued deductibility of home-owner property tax payments from the federal income tax base will be correspondingly weakened.

5. User Charges and Miscellaneous Revenues

This final, motley component of state-local revenue systems has exhibited impressive growth during the 1980s (Table 3). As noted earlier, together with benefit-based taxes, user charges provide the backbone of a sound subnational revenue system. In a recent staff report the ACIR concluded: "A greater reliance on user-charge financing would result in a more efficient level and mix of local public expenditures and would contribute to improved horizontal equity in local revenue structures." (ACIR, 1987, p. 55) Reaping these rewards will be no easy task, guaranteeing its sustained importance during the 1990s, but at least there is a good supply both of helpful experience and expert analysis (ACIR, 1987; Bird, 1976).

A more controversial and more rapidly growing source of state miscellaneous revenue has been the net proceeds of lotteries. These grew from $1.1 billion in 1980 to $5.6 billion in 1988, an average annual growth rate of about 23% (ACIR, 1990c, p. 128). Fourteen states set up lotteries before 1980, four in 1981-84, and eleven in 1985-86 (ACIR, 1990c, p.126). More may soon enter the game, but the high growth rates of the

1980s will be hard to sustain. Selling dreams may be as volatile an undertaking for governments as selling entertainment continues to be for the television networks (Clotfelter and Cook, 1989).

Conclusion

This paper has been able to deal only briefly with some of the most important of the many features that characterize Fiscal Federalism in Transition as the 1980s feed their budgetary trends and economic developments into the new decade. But enough has been said to indicate that there will be no lack of things to do for all players in the intergovernmental fiscal arena. Many changes are underway and more are bound to come. Let us hope that ten years from now we can look back at the 1990s as a period of solid, cooperative accomplishment.

Endnotes

[1] More specifically, a growth rate of 5.45% would be needed, compared to the 3.6% trend rate in 1948-89 (Carlson, 1990).

[2] Between 1979 and 1989 when consumer prices were rising at about 5.25% to 5.5% a year, as measured by the NIPA price deflator for Personal Consumption Expenditures and the Consumer Price Index respectively, the deflator for state-local government purchases of goods and services rose at an average annual rate of 5.75%.

[3] One might also include in the redistributive category the two states (New Hampshire and Tennessee) applying a single rate to nonwage income which, in general, is distributed more progressively than wage income.

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