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By Barry W. Poulson

The Heritage Foundation

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FISCAL FEDERALISM: A CONSTITUTIONAL APPROACH TO THE DEFICIT PROBLEM

by Barry W. Poulson

When Chuck Heatherly and I discussed this lecture last September, he suggested that I introduce a note of optimism since there is so much pessimism in Washington these days. After watching the budget negotiations over the last few months, I now understand why pessimism is so rampant. Bismarck is quoted as saying that "there are two things that one should never watch in the making, one is sausage, the other is legislation." I think that the quote does disservice to sausage makers, who at least produce something that people want. It is not clear that anyone wants the plan that emerged from the budget summit between the Reagan Administration and Congress.

The failures of federal fiscal policies have tended to obscure the success that state and local governments have achieved in bringing their fiscal houses in order. While the federal government has been accumulating massive deficits and public debt, the states have achieved remarkable success in pursuing more prudent fiscal policies.

Over the last decade, the share of state and local expenditures in state income has declined while the share of federal government expenditures in GNP has increased. The National Association of State Budget Officers projects that in real terms state expenditures will increase 2.6 percent in 1987, and 1.1 percent in 1988. In 1987, 24 states cut their budgets to bring expenditures in line with revenues, and 1988 budgets are expected to maintain existing services with selective program enhancements. Evidence of state frugality is also found in the decline in general fund year-end balances to slightly more than 1 percent of expenditures over the last decade. Further, 36 states have now adopted budget stabilization, or rainy day funds, to provide a buffer for state finances in periods of recession.

Tax Reform "Windfall." The state governments also have emerged with much stronger fiscal systems as a result of federal tax reform. For the 34 states where personal income tax is tied to the federal income tax, the tax reform act of 1986 created a $6 billion "windfall." About half of those states plan to return the windfall to taxpayers, and about half intend to keep all or part of it. Overall about 80 percent of the windfall will be returned to taxpayers. Federal tax reform will also result in increased corporate income taxes for the states, possibly as much as $3 billion per year.

A number of states have used the 1986 federal tax reform as a rationale for overhauling their own tax systems. Thus far 22 states have reduced the top marginal rate and increased standard deductions and personal exemptions for personal income taxes. They have created tax systems that are more equitable, with incentives for productive rather than transfer activities; as a result we can no longer view the

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states as woefully inferior to the federal government in the ability to finance government activities.

Constitutional and Statutory Constraints on the Fiscal Powers of State and Local Governments

The success of state and local fiscal policies reflects new rules of the game imposed since the tax revolt in the late 1970s to limit the growth of government. In addition to balanced budget provisions that exist in all but one state, twenty states have now adopted constitutional and/or statutory limits on their tax and spending powers. New Mexico just adopted such limitations in the past year. Limits on spending are determined by such factors as the rate of growth of personal income or population and the rate of increase of the price level. Other rules of the game that constrain the fiscal powers of state governments include: indexation of the income tax, gubernatorial line-item veto, fiscal note review procedures, and program evaluation and sunset laws.

The tax revolt will continue to revolutionize state and local fiscal policies in the years ahead. In states that provide for citizens' initiative and referendum, proposals for tax/expenditure limitations regularly appear on the ballot. While these citizen initiatives often do not result in legislative action, they serve to remind legislators of the cost as well as the benefit side of state and local fiscal policies.

Reduced Growth Rate. Economists writing in the public choice literature are beginning to provide evidence regarding the impact of constitutional and statutory constraints on the fiscal powers of state and local governments. If we examine the twenty states that have adopted tax/expenditure limitations, we find that these constraints have had a significant impact in reducing the rate of growth of the government sector. With only two exceptions the share of government in state income increased rapidly up to the tax revolt of the mid-1970s and has declined since then. If we compare these twenty states with states that did not impose these constraints, the evidence suggests that the former were more successful in reining in the growth of the government sector after the tax revolt. Alaska and Montana are exceptions to this trend in relying upon severance taxes rather than income taxes, and as a result, their revenues and expenditures are dominated by the vicissitudes of the energy sector.

Economists have employed a variety of econometric techniques to examine this issue more rigorously. An early study by the Advisory Commission on Intergovernmental Relations using regression analysis found evidence that tax/expenditure limits had reduced significantly the rate of growth of government spending in the 1970s.[1] Peter Skaperdos, of the New York Federal Reserve Bank, designed an econometric model showing that the tax revolt significantly reduced the rate of growth in government spending during the late 1970s and early 1980s.[2] The

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1. ACIR(1977A). "State limitations on local taxes and expenditures." Washington, D.C.: Advisory Commission on Intergovernmental Relations.

2. Peter D. Skaperdos, "State and Local Governments: An Assessment of Their Financial Position and Fiscal Policies." Federal Reserve Bank of New York *Quarterly Review*, Winter 1983-1984, pp. 1-13.

Skaperdos study did not distinguish between discretionary reductions in taxes and spending and constitutional or statutory limits on the rate of growth of taxes and expenditures. This year a paper by Rowley *et al.* tested the separate impact of constitutional and statutory limits on the rate of growth in state taxes, expenditures, and borrowing.[3] They found evidence that states with constitutional constraints reduced the rate of growth of the public sector significantly; the rate of borrowing in these states was reduced by roughly half. Interestingly, in their analysis they found that neither statutory limitations nor the line-item veto was significant. A limitation of the Rowley study is the use of cross-section data for the single year 1982, a year in which the states were scrambling to increase tax revenues as a result of the sharp recession. Their study suggests that constitutional constraints limit the growth of the public sector of states at a given point in time; it does not address the question whether such constraints are effective in a given state over a longer period of time, especially over a period of time long enough to encompass the tax revolt and the business cycle.

Colorado Experience. These limitations in the existing literature provide the rationale for our time series analysis of tax/expenditure limitations. Preliminary work on the state of Colorado suggests that the 7 percent cap on the annual rate of increase in spending that was introduced in 1978 has reduced the increase of state expenditures by about one fourth compared to the spending that would have occurred in the absence of that limit. However, the major impact of the limit may have been to change the composition of expenditures. Some expenditures, including education, highway construction, and water projects, remained outside the spending cap. Not surprisingly, these unconstrained expenditures increased rapidly while other expenditures grew at rates at or below the 7 percent cap. If these two categories of expenditures are combined, it shows that the total even grew at rates exceeding the cap during some years. This Colorado experience suggests that, if the major goal is to limit the growth of the public sector, then a more comprehensive limit on expenditures is needed.

It may also be true, as the Rowley study suggests, that statutory constraints do not inhibit the growth of the public sector to the same extent that constitutional limits do. In this view, the statutory limits are simply one form taken by interest group politics in influencing fiscal policy, not a constraint on the ability of interest groups to expand the public sector. Indeed the changes in the composition of expenditures in Colorado can be explained in terms of an interest group approach to public policy, as the model suggests. The expenditures that accelerated after the spending limit was introduced tend to contribute to economic growth while the constrained expenditures include transfer programs that tend to have negative impacts on economic growth. Legislators and interest groups trying to promote economic growth would favor such a change in the composition of state expenditures even if spending limits had no impact on the rate of growth in total spending. In order to better answer these questions, we are expanding the study to look at other states that have introduced tax/expenditure limitations and compare fiscal policies in these states with those for states without such constraints.

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3. Charles K. Rowley, William F. Shughart, and Robert D. Tollison, "Interest Groups and Deficits," in James M. Buchanan, Charles K. Rowley, and Robert D. Tollison, eds. *Deficits* (London: Basil Blackwell, 1987), pp. 263-280.

Unresolved Issues. The present study should be viewed as part of a broader literature examining the impact of tax/expenditure limits on the fiscal policies of state and local governments. While we are far from a definitive answer, the preliminary evidence suggests that these constraints do reduce the rate of growth of the public sector. However, there are a number of unresolved issues in this literature. Do constitutional provisions limit the growth of the public sector more effectively than statutory provisions? The intuition here is that constitutional provisions reflect citizen input, which places these limits in the category of fundamental rules of the game, whereas statutory provisions are closer to discretionary policy and therefore less effective in constraining public officials. A similar issue involves the requirement for a super-majority vote to suspend tax/expenditure limitations. In some states, legislators can evade these limits by such measures as shifting expenditures off budget or borrowing from trust funds. There also are states that have simply ignored these constraints, expanding taxes and expenditures in excess of the prescribed limits. It is not clear what sanctions are available to enforce these limits, or whether the courts will take an active role in assuring that the limits are enforced.

While the focus of our study is on tax/expenditure limits, it is clear that this is only one of a variety of techniques available to constrain the growth of the public sector. As we noted earlier, states have a variety of other tools including debt limits, line-item veto, and rainy day funds. The effectiveness of tax/expenditure limits depends to some extent on the use of alternative policies. For example, in Colorado the line-item veto has rarely been used, and in several cases it has been successfully challenged in the courts. Thus the spending limit in Colorado has been the major tack taken in constraining government. In contrast, in California the line-item veto has been used hundreds of times in recent years, which suggests that tax/expenditure limits may be less important in the overall strategy to limit government expenditures.

Implications for State and Local Fiscal Policy

In the new environment created by the tax revolt there is a growing competition among states to design fiscal policies that will attract business investment and promote economic growth. This interstate tax competition has accelerated since the recent federal income tax reform. With reductions in the federal marginal tax rate people have become more sensitive to the marginal tax rates in the various states and localities. For high income individuals, a reduction in the federal marginal tax rate from 50 percent to 28 percent means that every dollar they now pay in state and local taxes costs the taxpayer 72 cents rather than 50 cents. Mobile labor and capital resources are attracted to states where they can earn the highest real return, and state and local taxes now have a greater impact on that real return than at any time in the past.

The literature on interstate tax competition provides insight into the way tax/expenditure limits affect economic growth. To the extent that tax/expenditure limits impose constraints on the rate of growth of government, they help to create a more competitive economic environment. A wealth of evidence indicates that, when states and cities have not restrained the rate of growth of the public sector, it has resulted in lower rates of economic growth. States such as California have learned this lesson the hard way after losing industries and jobs to surrounding states with more prudent fiscal policies. California in recent years has imposed constraints on

the rate of growth of the public sector, which has resulted in rapid growth and increasing job opportunities. Cities such as New York that were virtually bankrupted by imprudent fiscal policies in the mid-1970s have experienced rapid recovery in the last decade after they were forced to pursue more conservative fiscal policies.

Flat-Rate Tax. The experience in my own state, Colorado, illustrates how fiscal prudence contributes to economic growth. During the period of rapid economic growth in the late 1970s and early 1980s, the existence of a spending cap held the growth of government in check. The decline in energy prices and recession in 1982 launched a period of slower economic growth in which state and local governments raised taxes to offset declining revenues. However Colorado is one of many states that have used federal tax reform as a rationale for major reform of the state tax system. Colorado introduced a flat rate of 5 percent on personal income which replaced a graduated rate structure with rates from 3 percent to 8 percent. The flat-rate tax captured about half of the windfall in increased revenues and returned about half of that to the taxpayers. Colorado adopted the federal levels for the standard deduction and personal exemption which removed the lowest income groups from the tax rolls altogether. A supply-side rationale underlies the Colorado tax reform just as it does the federal tax reform. Lower marginal tax rates for most taxpayers increase the incentives for work, savings, investment, and productive activity versus leisure and consumption. The new tax is simpler, reducing the amount of time involved in tax compliance and tax avoidance. Colorado has emerged with a fiscal policy that is more equitable as well as more efficient, contributing to a more competitive economic environment.

The Colorado experience is not unique. Thus far eleven states have reduced their top marginal rate, and ten states have decreased the number of tax brackets. Further, sixteen states have raised personal exemptions, and seventeen states have increased standard deductions. The result of interstate tax competition is a convergence of tax systems, which will limit the growth of the public sector and contribute to economic growth.

Tax Structure. The structure of taxes is as important as the level of taxes in enhancing the rate of economic growth, and the literature on interstate tax competition provides insight into this issue as well. States that rely on broad-based income taxes with low marginal rates create a more attractive economic climate than do states relying upon more narrowly based tax systems. Property taxes, for example, are narrowly based and tend to fall disproportionately upon the higher income and more mobile segments of the population. Severance taxes are less likely to affect the mobility of factors of production, but tend to fall disproportionately upon the mineral and energy sectors, which have been hard hit in the recent recession. Excise taxes also fall disproportionately upon specific industries and narrow segments of the population. Sales taxes are more broadly based, but fall disproportionately upon the lower income segments of the population.

User fees as an alternative to taxes prove to be a very efficient way to finance government activities. Since user fees impose costs upon the recipients of government services, there are fewer disincentives associated with this form of financing than there are with taxation. Deficits, on the other hand, have clear disincentive effects. Deficits are simply taxes deferred to some future time period;

they signal to business not only a future tax liability, but also a failure of government to bring expenditures into line with revenues.

The structure of expenditures as well as the structure of taxes significantly affects the rate of economic growth. The literature on interstate tax competition suggests that expenditures that enhance physical or human capital contribute to higher rates of economic growth. Thus expenditures for highways and other capital projects, for health, and for education expand productive capacity. On the other hand, expenditures to provide more amenities or to offset the lack of amenities enhance economic growth only modestly. Expenditures for natural resources, parks and recreation, sewage and sanitation, or public safety yield benefits that may not offset the costs of financing these public services.

Massachusetts Lesson. Perhaps the most important evidence is the negative impact of government transfers on economic growth. In Massachusetts, for example, the rapid growth of the public sector in the 1960s and1970s was tied to expansion in welfare programs. Massachusetts ranked first in the nation in the level of welfare expenditures per capita; it also had one of the highest levels of taxation per capita. Massachusetts was able to constrain the growth of the public sector by reducing the rate of growth of welfare expenditures in the late 1970s and 1980s, a period that saw acceleration in the rate of economic growth.

The lesson learned by Massachusetts has not been lost on other states. Since the tax revolt, states have been very cautious in funding the so-called entitlement programs. Most states do not provide automatic cost of living adjustments for Aid to Families with Dependent Children; increases in those benefits come from general revenue funds, and given the constraints on these funds, they must compete with other expenditure priorities of the states. For fiscal 1988, 22 states did not appropriate additional revenues to provide for cost of living increases; of the states that did provide cost of living increases, only six had increases above 5 percent.

Such prudence in fiscal policies reflects a growing awareness of the importance of state policies in promoting economic growth. Fiscal constraint is part of a broader strategy that includes policies to create more competitive labor and capital markets by deregulating markets and policies to privatize public sector activities. The literature on interstate tax competition reveals that these institutional changes combined with fiscal prudence create a competitive economic environment that is attractive to new business investment and economic growth.

Implications for Federal Fiscal Policy

These revolutionary changes in state and local fiscal policies have not been matched at the federal level. Indeed the decade since the tax revolt was launched has witnessed a deterioration in the federal government's fiscal position that must be regarded as a national crisis. Unconstrained growth in government spending combined with tax cuts has resulted in massive deficits and public debt. The ability of the federal government to resort to borrowing and the printing press permits a profligate fiscal policy that, thankfully, is impossible at the state and local level. However the stock markets are apparently signalling that the federal government has

reached a limit to this red ink; continued expansion in spending and deficits may no longer be tolerated.

Growth As Usual. The obvious question is why the tax revolt has not constrained the federal government in the way that it has constrained state and local governments. Constitutional and statutory provisions at the federal level have not prevented rapid growth in the public sector or an increasing share of the federal government in GNP. The Gramm-Rudman-Hollings bill initially called for major reductions in federal deficits, but those original targets were quickly abandoned and the federal government continued to grow as usual. This year a budget reconciliation package has been introduced to preclude the automatic cuts that would result from a watered-down version of Gramm-Rudman-Hollings. While that budget may resolve the current crisis, it does little to address the long-run problem of rapid growth in federal spending.

The failure of statutory approaches to constrain federal expenditures reveals the need for constitutional provisions for a balanced budget and spending constraints for the federal as well as state and local governments. The success of constitutional constraints at the state and local level supports the argument that such provisions would constrain the federal government more effectively than Gramm-Rudman-Hollings or other statutory provisions. However, it is important to point out that the federal government faces political pressures different from those encountered at the state and local level. It is easier for interest groups to lobby one federal legislature than 50 separate state legislatures. For those adversely affected by such logrolling, it is difficult to identify the costs of federal government programs, and even more difficult to convince taxpayers that something should be done. If the experience with Gramm-Rudman-Hollings is any guide, federal legislators probably would circumvent the constraints imposed by a constitutional as well as a statutory limit on government spending, for example, by shifting expenditures off budget or borrowing from trust funds. The implication is that alternatives to a constitutional amendment to balance the budget and limit federal spending should also be pursued.

"Devolution By Default." The greatest promise for limiting the growth of the federal government lies in devolution and fiscal federalism. In fact, the fiscal problems of the federal government have already forced a *de facto* devolution in which state and local governments have been forced to assume programs by default. Last year the $4.6 billion federal revenue sharing program came to an end; and the federal grants-in-aid program is projected to decline by 2.2 percent in 1987, and 3.3 percent in 1988. The budget reconciliation package may force even deeper cuts in federally funded programs. State and local governments have been forced to assume more responsibilities with a declining flow of resources from the federal government; we can refer to this as "devolution by default." "Devolution by default" may relieve the federal government's fiscal burdens, but it is not likely to achieve an optimum balance of government responsibilities in our federalist system.

The planned devolution that occurred early in the Reagan Administration suggests that devolution does offer a viable option in establishing a new federalist system. Under block grants and more flexible rules, state and local governments were able to better allocate resources in federally funded programs.

State and Local Innovations. In areas such as health and education, the states stepped in to increase funding to more than offset the cutbacks in federal funding. More important, they reorganized existing programs and allocated funds consistent with their own priorities. State and local governments have taken the lead in experimenting with innovative programs in health delivery systems to contain costs, vouchers and magnet schools that offer choices in education, and training and workfare programs that give welfare recipients an alternative to dependency. Some programs, such as Community Action Agencies, which existed only because of the availability of federal funding, have been abolished. But other programs have been maintained in the face of federal cutbacks: when funding for day care centers was reduced, the level of service was maintained by combining increased state funding with better management of resources.

This year eighteen states have increased aid to local governments to offset the decline in federal revenue sharing funds. As federal funding has declined, state and local governments have searched for innovative approaches to the provision of public services, relying increasingly on the private sector. Private providers now play a major role in providing food and shelter for the indigent, in day care, in neighborhood development programs. The result has been a virtual explosion of creative programs in the provision of social services, with intermediating organizations--including tenant management groups, church-based development associations, and independent schools--now playing a principal-agent role between the family and the state.

Greater Share of Burden. State and local governments should use their success and greater bargaining strength to influence the way in which devolution occurs. Devolution should not occur by default as the federal government withholds financial support in the name of financial exigency. It is clear, however, that devolution cannot occur in a revenue neutral manner such as that proposed in the federalism act of 1986. Such proposals, which presuppose a continued expansion in federally funded programs and a sorting of existing programs between different levels of government, ignore the revolutionary changes that have occurred in fiscal policy since the tax revolt. The federal government simply does not have the resources to finance the projected growth in existing programs, let alone new programs. The state and local governments with greatly strengthened fiscal systems will need to shoulder a greater share of the burden with a diminished flow of resources from the federal government.

The current fiscal crisis should provide an opportunity for state and local representatives to take a leadership role in planning and designing devolution in a new fiscal federalism. Such federalism should reflect a balance between the states and the federal government closer to that envisioned in the Constitution than to that which has occurred as a result of the unconstrained growth in the federal government in recent decades.