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DR. GERALD FAVERMAN, Chairman of the Board

A LETTER OF POLITICAL AND SOCIAL COMMENTARY

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TO: FISCAL AWARENESS SERVICE Subscribers

FROM: Robert Kleine and Gerald A. Faverman

SUBJECT: FEDERALISM: A REALIGNMENT OF RESPONSIBILITY

The scope of current legislative debate on the Michigan income tax rollback must be broadened to incorporate developments in other political arenas. The State's ability to operate with $400 million less annual revenue (the approximate effect of a .5 percent rollback) depends not only on the strength of our economy, but also on actions at the national level. There is currently much uncertainty in Washington about such major issues as federal tax reform, the federal budget deficit, and the future course of intergovernmental funding relationships and responsibilities. In view of this uncertainty, Michigan would be well advised to be cautious.

Much has happened in recent years to change the political and fiscal environment in which the states must operate. To begin with, there has been a fundamental change in the federal government's relations with state and local governments. President Reagan has been trying to shift program responsibilities from the national level since he took office, but intergovernmental relations were starting to change even before his administration.

In the 1950s and 1960s, state and local spending, as a percentage of gross national product (GNP), was increasing much faster than federal spending, encouraged in part by large federal aid flows (see Table 1). From 1959 to 1974, state-local spending increased from 9.6 to 14.3 percent of GNP, while federal spending increased from 17.2 to 17.8 percent of GNP.[1] Since then, state-local spending as a share of the GNP has fallen. The actual levels of federal, state, and local spending since 1954 are shown in Figure 1.

TABLE 1
GOVERNMENT SPENDING AS PERCENTAGE OF GROSS NATIONAL PRODUCT

| Year | State-Local | Federal | Total |
|---|---|---|---|
| 1959 | 9.6% | 17.2% | 26.9% |
| 1969 | 12.6 | 17.8 | 30.4 |
| 1974 | 14.3 | 17.8 | 32.1 |
| 1980 | 13.5 | 19.5 | 33.0 |
| 1984 | 12.9 | 21.5 | 34.4 |

[1] Years listed throughout this letter are fiscal years. The year named refers to that in which the fiscal year ends.

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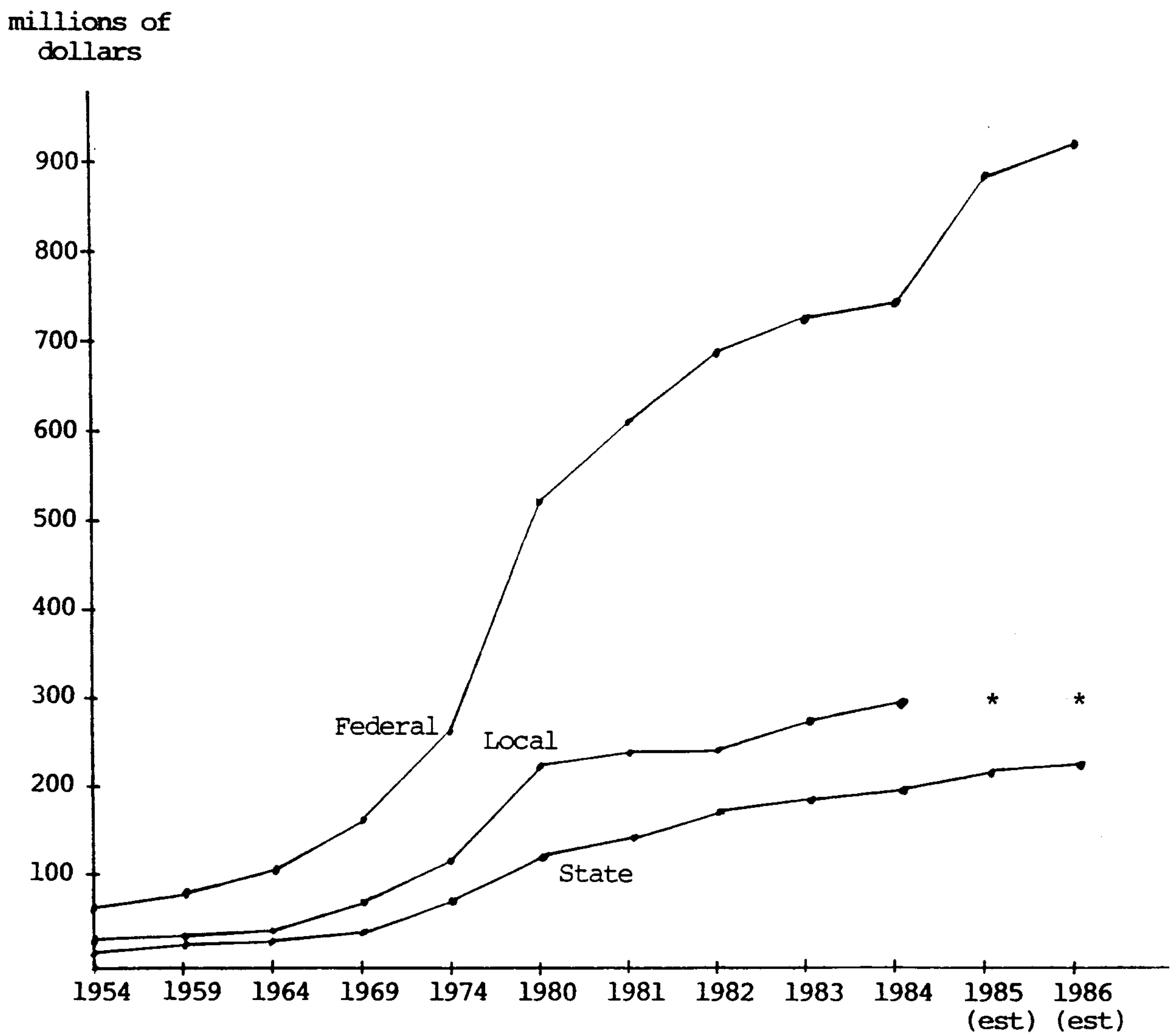
PUBLIC SECTOR CONSULTANTS, inc.

KNAPP'S CENTRE ● 300 S. WASHINGTON SQUARE ● SUITE 401 ● LANSING, MI 48933 ● (517) 484-4954

FIGURE 1
GOVERNMENT SPENDING FOR SELECTED YEARS, 1954-86
(AFTER INTERGOVERNMENTAL TRANSFERS)




*Not available.

Another view of this change is presented in Table 2. From 1979 to the current fiscal year (1986), federal spending has increased at an annual rate of 10.3 percent compared with an 8.6 percent rate of increase in state budgets. In Michigan, the annual growth in spending during this period averaged only 5.9 percent. The comparison between federal and state spending would have been even more dramatic except for the sharp reversal this year, when federal expenditures are projected to increase only 2.5 percent compared with an 11.4 percent increase in state spending.

TABLE 2
ANNUAL STATE AND FEDERAL BUDGET INCREASES

| Year | Federal | All States | Michigan (GF-GP) |
|---|---|---|---|
| 1979 | 9.6 | 10.1 | 10.8 |
| 1980 | 17.5 | 10.0 | 13.6 |
| 1981 | 13.9 | 16.3 | -7.8 |
| 1982 | 10.8 | 6.4 | 1.2 |
| 1983 | 9.3 | -0.1 | 10.2 |
| 1984 | 5.8 | 7.9 | 9.0 |
| 1985 | 12.5 | 6.7 | 8.9 |
| 1986 (est.) | 2.5 | 11.4 | 7.0 |
| 1979-86 (average) | 10.3% | 8.6% | 5.9% |

In the mid-1970s state-local spending began to slow. (See Table 1.) This slowdown can be attributed to the three Rs--recessions, revolt of the taxpayers, and reductions in federal aid.

Recessions: The serious recessions of 1974-75 and 1980-83 sharply slowed growth in state-local revenues, causing budget cuts and resulting in fewer new program initiatives.

Revolt: The taxpayers' revolts that began with the passage of Proposition 13 in California in 1976 placed constitutional and statutory restraints on state-local spending in many states. Even more important has been the change in the political atmosphere, from one favoring expansion of government to one favoring less government.

Reductions: The federal government began to slow the growth of aid to state-local governments in the late 1970s. Federal aid as a share of state-local revenue peaked at 31.7 percent in 1978 and is estimated at only 21.4 percent for 1986. The decline in federal fiscal support of state-local governments reflects both a change in philosophy and the federal government's budget problems. During the past five years the total federal debt has about doubled to $2 trillion--49 percent of GNP and $8,500 per capita. Interest on the debt has increased from $54.5 billion in 1980--9.1 percent of outlays--to an estimated $143 billion in 1986--14.7 percent of outlays.

Forces are at work that could cause further changes in the patterns of government spending--federal spending is likely to slow, requiring state-local spending to increase to maintain programs and services. As the federal government continues to reduce aid to state and local governments to reduce its huge deficits, the lower levels of government will largely be left to their own resources. We are entering an era of "do-it-yourself" federalism in which state and local governments must fend more for themselves. State governments will come under considerable pressure to increase aid to local governments.

The passage of the Gramm-Rudman balanced budget bill at the federal level will likely shift more responsibility to state-local governments and will almost certainly lead to large cuts in grants-in-aid to state-local governments. The ability of state-local governments to shoulder these new fiscal responsibilities could be constrained if the deductibility of state-local taxes from federal income taxes is eliminated. Paying state-local taxes is more palatable when taxpayers recover up to 50 percent of their payments from the federal government. State-local governments may dodge the bullet this time as current signals from Washington indicate that broad tax reform is dead and that any bill that <u>is</u> passed will retain deductibility of most state-local taxes.

Returning responsibilities to state and local governments has many potentially positive aspects such as increasing political accountability, improving the efficiency of service delivery, and encouraging experimentation with creative, new ways of solving social problems. However, in the short run painful adjustments will be required, and officials at all levels of government must understand, and be prepared to operate in, this new environment.

We believe that Michigan may be ill-prepared to operate in this new environment unless it has sufficient fiscal resources and flexibility to deal with unanticipated budget demands, which could include having to assist local governments fill funding gaps left by federal cutbacks. A income tax rollback of .5 percent would allow, at best, only a 2 to 3 percent increase in the 1987 budget, an increment not only inadequate to be of much help to local governments, but also inadequate to increase contributions to the Budget Stabilization Fund (BSF).

Public Sector Consultants, Inc. has consistently maintained that it is in the public interest to build up balances in the BSF (the "rainy day fund"), the purpose of which is to protect funding of state programs in times of economic downturn. Another recession is probable at some point, and unless the state is prepared we will repeat the painful experiences of the early 1980s. We recommend that the BSF be built up to about 10 percent of the total of general fund-general purpose and school aid revenues; this would amount to about $800 million.

For these very substantial reasons, Public Sector Consultants, Inc. urges caution in the debate about the income tax rollback. While there are clear political benefits to be derived from an early rollback, the larger fiscal effects must also be considered.

This commentary is a publication of the FISCAL AWARENESS SERVICE. We hope you have found it interesting.

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