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FEDERAL-STATE-LOCAL FISCAL RELATIONS: A REVIEW OF THE TREASURY REPORT

DAVID E. WILDASIN
Indiana University

In 1983 Congress passed legislation that, among other things, directed the Secretary of the Treasury to conduct a series of studies on intergovernmental fiscal relations. These studies culminated in a report entitled *Federal-State-Local Fiscal Relations,* presented to Congress in September, 1985 and appearing in printed form in 1986.[1] This is an important document that scholars, policy analysts, and others seriously concerned with major policy issues in intergovernmental fiscal relations will wish to consult for years to come. The purpose of this article is to provide a review of the Treasury report.

The review is organized in two major sections. In the following section I present a chapter-by-chapter critical summary of the entire report. Although it is of course impossible to go into great detail, this survey will inform readers about both the general structure and some of the specific contents of the report. I hope that the survey will also contribute to more efficient use of the report by those who wish to see what it has to say on certain relatively narrow questions, but who may not be inclined to read the report in its entirety. The second section provides an overall evaluation of the report from two perspectives. First, I consider its relevance for and possible impact on policymaking. Second, I evaluate the report in terms of its role as a summary of the state of the art in the economics of fiscal federalism.

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AN OVERVIEW

For the purposes of organizing this review, I find it useful to group the substantive chapters of the Treasury report into four main parts. First, Chapter II (22 pages) reviews the basic economic principles of fiscal federalism. The next four chapters (122 pages) describe the history and current state of intergovernmental fiscal relations in the United States. The third part comprises Chapters VII-XI (225 pages), and discusses current policy issues such as methods of distributing Federal aid to states and localities, the measurement of fiscal capacity, the Federal income tax deductibility of state and local taxes, and exemption of state and local bond interest from Federal taxation. This part of the report relies heavily on economic analysis, and should therefore be of substantial interest to public finance economists. The last part, Chapters XII and XIII (44 pages), covers the history and prospects for reform of the federal system. In addition to these main sections, the report includes some 50 pages of summary and introductory material, and 70 pages of addenda, containing letters and reports reflecting the views of state and local officials who were invited to comment on the report. Clearly, this is a very wide-ranging study. It will be useful to review the contents of each of these four main parts, and then to discuss briefly some of the invited comments.

THEORY

Chapter II of the Treasury report summarizes much of the received theory of fiscal federalism in an economically correct but nontechnical fashion. Much of the discussion here covers such basic topics as public goods and externalities, Musgrave's three branches of the public sector, interjurisdictional benefit spillovers and the role of matching grants as a corrective mechanism for them, and the Tiebout principle of using a federal system as a mechanism for adapting the public sector to diverse preferences for public services. All of this will be familiar to economists who have read Oates (1972), a standard reference in this field, or even general undergraduate textbooks on public finance. There is also a discussion of the role of equalizing grants to subnational governments, essentially on the grounds of horizontal equity and avoidance of fiscally induced migration developed many years ago by Buchanan and given textbook treatment, e.g., in Boadway and Wildasin (1984).

This chapter certainly breaks no new theoretical ground. Moreover, there are a number of important basic issues in fiscal federalism that are not discussed here. For example, problems of tax competition and tax exporting are given rather short shrift, although they get some attention later in the report. Moreover, there is a tendency to accept the identification of the behavior of state and local governments with the preferences of their residents that may be a bit too casual. For example, we are told (p. 15) that if 20% of the benefits of local police services accrue to those outside of a given city, and if the city receives a matching grant whereby 20% of the cost of the service is paid by the state, "the decision of [the municipal] government on the allocation of resources to the services could . . . be presumed to be optimal." Since those who have attempted to evaluate the efficiency of local public spending have, on various occasions, found evidence of both over- and under-provision of local public services, this presumption seems a bit dubious. However, one should probably regard this chapter as an attempt to provide a simple introduction to a basic conceptual framework, rather than as a more comprehensive survey of major theoretical principles. Seen from this perspective, the chapter is a useful contribution to the study as a whole.

HISTORY AND CURRENT STATUS OF AMERICAN FEDERALISM

Chapter III of the report provides a considerable amount of historical background, both economic and legal, on the development of the U.S. federal system. It includes basic statistical data, and accompanying descriptive text, showing the trends in revenue, expenditure, indebtedness, and intergovernmental transfers, for the Federal, state, and local governments, over the period 1902-1983.[2] This information will be familiar, at least in its broad outlines, to most public finance economists. It reveals that certain structural features of the system, such as Federal reliance on the income tax and local reliance on the property tax, have persisted over considerable periods of time. Other features show some change, particularly in recent years: State and local revenues have grown relative to Federal revenue, Federal indebtedness has grown substantially since 1980, and Federal transfers to states and localities, which grew at a rapid rate through the 1960s and 1970s, have been cut back substantially in the 1980s.

Aside from the statistical information, this chapter provides a general survey of the changing roles of the Federal and state governments over the years, touching on such matters as the debate over the incorporation of a national bank, the use of Federal land grants and their influence on the states, the nullification and states' rights controversy, the introduction of the Federal income tax in 1913, and the New Deal. There is also a fairly extensive discussion of the doctrine of tax immunity, which concerns the extent to which the Federal government and the states can tax each other. One reason that this issue deserves special attention is that it bears on the constitutional feasibility of Federal government taxation of the interest on bonds issued by lower-level governments. After a detailed review of a number of relevant cases, the Treasury report concludes that "the doctrine of reciprocal immunity with respect to Federal taxation of State entities has been repudiated" (p. 73). If this conclusion is correct, then there appear to be no fundamental legal impediments to elimination of the exemption of state-local bond interest from Federal income taxation.

Finally, Chapter III discusses the implications of Federal regulatory policy for state and local governments, addressing in particular the issue of "compensation," that is, payments by the Federal government to these governments to compensate them for the cost of compliance with Federal regulations. This section is rather out of place in a chapter on the history of the Federal system, but, in any event, it raises a number of interesting issues. The nature of the problems that arise here can be illustrated with two examples. First, the report cites a Federal regulation requiring the installation of elevators and ramps at every subway station in New York City and Washington, D.C., in order to provide access for the handicapped. In response to this, both cities proposed to offer free taxi service to the handicapped, a less costly alternative that was, however, rejected by Federal officials. Some legal wrangling ensued, with the result that the original regulations were relaxed. But suppose they had not been. Is it good policy to allow the Federal government the authority to impose potentially very large costs on lower-level governments by the stroke of a regulator's pen? Second, the report mentions the claim made by state and local officials that they are entitled to Federal compensation in the wake of recent court decisions requiring them to provide education for the children of illegal aliens, on the grounds that this demand for their services arises from a failure by the Federal government to control the nation's borders properly. As the report points out, this type of reasoning might be extended to the conclusion that all relief services for the poor must be Federally funded, because poverty is the result of failed Federal policy. These two examples suggest that there is a judicious balance to be struck between two extremes, and the Treasury report provides some tentative guidelines for doing so. It emphasizes, however, the complexity of the issues. This appears to be an area that would repay careful analysis by economists interested in policy issues.

Chapter IV of the Treasury report is devoted to the "current state" of the American federal system. It identifies several "favorable" and "unfavorable" recent developments. A notable example is the finding that states and localities were in "fundamental disequilibrium" for three decades after World War II, owing to increasing service demands (caused for example, by the baby boom) unaccompanied by automatic revenue growth. "As a consequence, the States and localities were forced to raise taxes at an unprecedented pace" (p. 95). Now, however, these pressures have subsided, and the States and localities are in "fundamental fiscal equilibrium." By contrast, "the Federal sector is facing a substantial period of fundamental fiscal disequilibrium" (p. 100), so that "it is not likely that there will be much budgetary room available throughout the 1980s for programs whose justification for national policy is questionable" (p. 101). This equilibrium/disequilibrium theme appears again later in the Treasury report, and it is interesting, therefore, to reflect on exactly what it might mean.

It would seem that a government is in "disequilibrium" if it raises its expenditures and raises its taxes to avoid a deficit, and that the ability to maintain current expenditures at constant tax rates implies "equilibrium." When in "disequilibrium," a government does not have the latitude to pursue programs of "questionable" justification, while perhaps this is not true for a government in "equilibrium." Some readers might object to this rather nebulous terminology, however. Proponents of limited government might argue, for example, that high taxes and expenditures, even when they produce a fiscal surplus, represent a "disequilibrium." Others might argue that raising taxes to pay for more schools for the baby-boom generation no more represents a "disequilibrium" than the purchase of larger amounts of heating oil by a household in the winter than in the summer. (Is it more correct to say that one is "forced" to buy oil in winter, or to say that one has the "luxury" of not buying it in the summer?) Thus, it is difficult to attach precise meaning to some of the concepts used in this discussion. However, they provide a basis for some of the more important policy evaluations made in the report, as we shall see later.

State-local fiscal relations are the topic of Chapter V. This chapter surveys the structure of local government in the United States and discusses the pattern of state and local revenue and expenditure, and of state aid to local governments, in the recent past. This chapter is essentially descriptive in nature, and provides useful background information. It performs well what is probably its most essential task, that is to say, it emphasizes and justifies the view that "the overwhelmingly most important reality of the 50 State-local fiscal systems is their extraordinary diversity" (p. 103).

Finally, Chapter VI identifies five main types of Federal aid to states and localities—categorical grants, block grants, general fiscal assistance (revenue sharing, Federal payments in lieu of taxes), Federal income tax deductibility of state-local taxes, and the exemption from Federal income taxation of interest on state-local bonds. Tabulations provide a breakdown, by state, of each of these types of aid.

In summary, Chapters III-VI of the Treasury report provide a useful general survey of outstanding features of the U.S. federal system in the past and present. Most of this material is inessential to the report from the viewpoint of its policy analysis and recommendations, and is already available in other sources.[3] However, it is valuable for the sake of balanced perspective and completeness to have it included. This is especially so since, as a major governmental study, the report will be examined by many nonspecialists. Specialists may find occasional sections of interest, but can pass over most of this part of the report, at least on first reading, with little loss.

ECONOMIC ANALYSIS

Of the five chapters in this part of the Treasury report, the first two, Chapters VII and VIII, each deal with different aspects of Federal government grant policy toward state and local governments.

The first of these chapters falls roughly into three parts. It begins by discussing the theoretical and empirical analysis of the impact of grants on recipient governments. It then discusses issues related to formulas for general fiscal assistance to lower-level governments, à la revenue sharing. The third part of the chapter contains more statistical material on the distribution of grant funds—material that need not be discussed further here.

In its treatment of the economic analysis of grant policy, the chapter contains a clear statement of the principal theoretical results in the area. There will be little here that is new or surprising to readers of standard works such as Oates (1972) or Break (1980). However, since the intended audience of the report is certainly very broad, it is important that these results be repeated in an easily understandable way. Thus, for example, we find a nice illustration of the equivalence of lump-sum categorical and

unrestricted grants, given that the level of categorical assistance is lower than the amount of expenditure that would have been undertaken in any case. The report also explains that closed-ended matching grants are equivalent to lump-sum grants once the upper limit of the grant is reached. There is also a discussion of maintenance-of-effort requirements, which attempt to limit the extent to which a recipient government can effectively turn a categorical grant to other uses by cutting its own expenditure in the aided category. The report points out that inflation and growth in desired real expenditure tend to weaken such constraints over time. In general the thrust of much of the theoretical discussion is that many forms of intergovernmental grants are in reality much closer to lump-sum transfers than they appear to be on the surface.

The review of the theory is followed by a survey of empirical work, spanning the past 30 years, on the impact of grants on recipient government spending. The emphasis in this survey is on the "bottom line," that is, on seeing what conclusions have been reached in the literature about the size of the increase in recipient spending per dollar of grant aid, without much attention to the technical theoretical and econometric issues. It appears that the estimates have been falling over time, and the report concludes that the evidence indicates substantial "leakage" of grant funds into tax reductions or into unassisted public expenditure categories. The report finds, however, that the Medicare and AFDC programs may be major exceptions to this rule, since both of these are financed by open-ended matching grants.

The second major part of Chapter VII deals with the principles and practice of general fiscal assistance, focusing particularly on the Revenue Sharing program. It outlines the Revenue Sharing formula, as well as other candidate formulas, and discusses various desiderata for the distribution of aid. The report mentions that equalizing grants might affect the interjurisdictional migration of households and firms, and that they may affect the distribution of income among individuals. It dismisses these effects as unimportant, however, essentially because the level of grants is too small to have a noticeable impact in either of these dimensions.[4] The focus of the discussion then shifts to the comparison of "foundation" and "power" equalizing grants. The former are lump-sum grants that enable each jurisdiction to achieve a specified "foundation" level of expenditure at a specified (e.g., national average) tax rate, regardless of the size of the jurisdiction's tax base. The latter are grants that would enable each jurisdiction to obtain the same level of total revenue (i.e., own-source tax revenue plus grant aid), at any tax rates it might impose, as if it had an average tax base. These grants thus equalize the taxing "power" of recipient governments. It is noted that the tax effort component of the Revenue Sharing formulas used in the United States is closer to the power equalization concept than to the foundation-type approach. The report finds that the choice between the two "is a policy decision on which normative economic principles offer only limited guidance" (p. 180), however. There ensues a rather detailed treatment of what might be described as "technical" revenue sharing issues, such as the implications of the 20% minimum to 145% maximum allocation rules and the problem of fund allocation within counties. These technical issues are of interest in their own right. They also point up the enormous general problem involved in having the Federal government attempting to deal, more or less directly, with tens of thousands of local governments.

Whereas Chapter VII of the report is closely tied to existing literature and policies, Chapter VIII, on measuring fiscal capacity, is more innovative. It may be the chapter in the report that will be of greatest interest to economists. Since measures of fiscal capacity often find their way into grant allocation procedures, it is also of very great policy importance. It begins with the fundamental conceptual problem of defining what fiscal capacity means. It then evaluates various existing and proposed fiscal capacity measures within its chosen conceptual framework.

The basic guiding principle of the Treasury report's approach to fiscal capacity is that any measure of fiscal capacity should take into account all potential sources of revenue open to a jurisdiction, whether these sources are exploited or not. The fiscal capacity measure should not depend on the taxing preferences of the

jurisdiction with respect to one tax source or another. This approach leads to criticism of the most widely-applied fiscal capacity measure in the United States, per capita personal income (PI). The problem with PI, from the viewpoint of the Treasury report, is that it is insufficiently comprehensive. To illustrate the problem with PI, consider a state in which a certain corporation conducts some of its operations. Suppose that this corporation is partly owned by households not residing in the state, and suppose that part of the profits of the corporation are distributed as dividends to shareholders. The portion of these dividends that accrues to nonresidents will not be added to the PI of the state. However, states can and do tax corporate profits. According to the Treasury approach, such corporate income does represent a potential revenue source, and ought to be included in fiscal capacity. For some states, income of this type (including also royalties and rents from natural resource extraction) is quantitatively important, and the Treasury therefore finds PI a seriously flawed fiscal capacity indicator.

The report also critiques the use of a representative tax system (RTS) approach to fiscal capacity measurement, although for somewhat different reasons. An RTS measure is typically obtained by calculating the amount of tax revenue and the amount of tax base (usually per capita) B_{ij} for each jurisdiction i and each tax base j. A reference tax rate t_j^* for each base is then obtained by summing the T_{ij} and B_{ij} across all jurisdictions and dividing one by the other:

$$t_j^* = \frac{\Sigma_i T_{ij}}{\Sigma_i B_{ij}}$$

An RTS measure of fiscal capacity for jurisdiction i is then determined by computing how much revenue it would obtain if it applied the reference tax rate to each of its tax bases

$$F_i^* = \Sigma_j t_j^* B_{ij}$$

If F_i^* is high, then, roughly speaking, jurisdiction i is well-endowed with the tax bases that tend to be heavily taxed by jurisdictions in general.

From the Treasury viewpoint, this measure is in principle more attractive than PI because it can be made quite comprehensive by including all sources of revenue. It would, for example, include corporate profits or natural resource rents accruing to nonresidents, since these bases are in fact taxed by states. However, the report identifies a number of technical issues arising in connection with the RTS (e.g., determination of the proper degree of disaggregation in defining tax bases, treatment of user fees). Also, more fundamentally, the RTS system effectively applies heavy weights to tax bases that are heavily taxed on average (high t_j^*), and low weights to bases that are lightly taxed low t_j^*). As the Treasury report makes clear, this could be an advantage of the RTS method if one supposes that existing tax rates reflect the "taxability" of different revenue sources. One could argue that sources that are "attractive" for taxation (for whatever reasons) will tend to be taxed more heavily, while those that are "unsuitable" for taxation will be taxed more lightly. One might think of the differences in tax rates between individual income, corporate income, and sales taxes as examples of this. However, one could alternatively argue that weighting different revenue sources differently is a disadvantage of the RTS method. If fiscal capacity is supposed to measure the resources available to jurisdictions for public expenditure, then it could be argued that the degree to which these resources are actually exploited, as indicated by tax rates, is irrelevant. It is this sort of reasoning that underlies the Treasury report's preferred approach, the measurement of Total Taxable Resources (TTR). This approach involves simply adding up, as nearly as possible, all of the income accruing to residents in the jurisdiction plus all corporate income, rents, royalties, etc. Thus, roughly speaking, TTR is more comprehensive than PI and, unlike the RTS method, the TTR approach does not weight different components of taxable resources differently.

This proposed fiscal capacity measure has attracted some attention since the publication of the report. Legislation has been introduced to direct Federal fiscal assistance to states with low levels of TTR. The Advisory Commission on Intergovernmental Relations (ACIR), which has advocated the use of RTS in lieu of PI for fiscal capacity measurement for some years, has recently published studies that carefully compare and contrast the two approaches.[5] These are indications that the Treasury report has helped to provoke new interest in the problem of fiscal capacity measurement, which, it is to be hoped, will result in further clarification of basic concepts and improvements in the technical procedures of assembling and manipulating data.

The next chapter in the report, Chapter IX, deals with two important problems related to the Federal individual income tax: the deductibility of state and local taxes and the exemption of interest on state and local bonds. Like nearly everything that has been written on Federal tax policy in recent years, the report has been overtaken by events and is now out of date. In particular, the report was written before the passage of the recent tax reform law that ended the deductibility of sales taxes. The issues raised in the report remain as important now as ever, however, so the discussion there is by no means obsolete.

On the deductibility issue, the report mentions what are probably widely regarded as the most important efficiency and equity problems with deductibility. It points out that deductibility may create an artificial incentive for state and local public spending, and that it may induce greater reliance on tax-deductible revenue sources (such as income and property taxes, and formerly sales taxes) as opposed to nondeductible sources (such as user fees and excise taxes, and, currently, sales taxes). It also observes that deductibility works to the relative benefit of high-income states and localities. In terms of possible benefits, the report cites deductibility as possibly offsetting competitive pressures among states and localities to cut taxes, and as mitigating fiscally induced incentives to migrate. It may also encourage the adoption of more progressive state and local tax structures.[6]

The report then tries to quantify the revenue loss to the Federal government from deductibility, the distribution of tax relief by income class, and the effective "benefits" to state and local governments from the implicit Federal subsidy embodied in deductibility. The estimates indicate that the Federal government loses about $35 billion in revenue annually, with this loss projected to increase substantially (ignoring the effect of the repeal of sales tax deductibility). Deductibility also definitely benefits higher-income households relatively more than lower-income ones, as evidenced by the proportion of itemizers and the percentage reduction in Federal taxes as a function of income class.

The benefit of deductibility to state and local governments is measured by the estimated increase in public expenditure that it causes. The fact that this measure is sensitive to the price elasticity of demand for public goods is well recognized, and results are presented for price elasticities ranging from 0 to .5. The estimated increase in state and local expenditure for 1982 ranges from $0-12 billion. The report thus concludes that this deductibility is an "inefficient" way of transferring funds to states and localities, on the grounds that it does not yield much bang ($6 billion as a preferred point estimate) for the Federal buck (the $35 billion loss to the Treasury). In some ways, this is a rather odd conclusion. First, if the demand elasticity for state and local public goods is sufficiently low that deductibility does not substantially simulate lower-level government public spending, then it follows that the *economic* inefficiency of deductibility, insofar as it encourages excessive state and local public expenditure, must be small. Second, as noted above, an earlier chapter cites open-ended matching grants as the form of Federal assistance likely to have a significant impact on recipient government spending. Since deductibility is argued to act like such an open-ended grant, it is hard to see why it is given a low "efficiency" rating. Certainly it is difficult to understand the conclusion that the "efficiency [of deductibility] is very low compared with direct Federal aid in the form of Revenue Sharing . . . which provides funds to local governments that equal more than 99 percent of the Federal

budgetary cost" (p. 273). This conclusion gives Revenue Sharing a high "efficiency" rating because Federal funds are put directly into the hands of recipient governments, but ignores the fact that a substantial amount of such aid eventually finds its way into private hands via tax reductions. The latter is certainly the relevant comparison, however, and it is indeed quite plausible (though not necessarily the case) that, taking such adjustments into account, deductibility might well stimulate recipient government spending more, per dollar of Federal revenue foregone, than lump-sum grants or grant with very low implicit matching rates.

In any event, the report considers a variety of proposals for reform, involving elimination or limitation of the deductibility of some or all state and local taxes. It clearly identifies the implications of these proposals for the choice of financing mix by lower level governments, noting, for example, that eliminating the deduction for sales taxes would increase the incentive to use other deductible taxes, as well as user fees and excises, more heavily. This discussion is certainly very topical, and the report here anticipates what will no doubt be the subject of a number of journal articles and doctoral theses in the next several years (at least if the Federal tax law remains stable, in its deductibility dimension, for more than one legislative session).

Federal income tax exemption of state and local bond interest is the second major topic treated in Chapter IX. This discussion identifies a number of major equity and efficiency problems raised by this feature in the tax code, most of which will be familiar to public finance economists. Thus, it is noted that ownership of tax-exempt bonds is concentrated in the hands of high-income households, which works to reduce the progressivity of the tax structure. It is also noted that the interest exemption creates a variety of sometimes perverse incentives. For example, it encourages state and local borrowing relative to other forms of finance. It creates opportunities for tax arbitrage, as, for example, when state and local debt is used to fund private borrowing for industry, residential housing, student loans, and the like.

In addition to identifying these and other equity and efficiency implications of the interest exemption, the report contains a wealth of information on the development of the tax-exempt bond market, the use of funds raised via exempts, the revenue loss to the Federal Treasury resulting from the exemption, and the benefit to lower-level governments in the form of reduced borrowing costs. Among many interesting findings, the growth of private-purpose borrowing is particularly notable: Substantially more than half of tax-exempt borrowing is used to finance what are described as "private-purpose" programs. There might be room for quibbling about whether borrowing by nonprofit private institutions such as hospitals or educational institutions should be treated as private-purpose (as the report does) or as public-purpose, but there seems no doubt that a substantial level of tax arbitrage is being undertaken through state and local financing of residential housing and private business (via industrial development bonds).

A number of possible reforms of the treatment of state and local borrowing are discussed, including complete elimination of the exemption (the constitutional feasibility of which has been discussed earlier) as well as less ambitious reforms such as tightening up the regulations on the use of this exemption for private-purpose borrowing. An important point that runs through this discussion is that even if the Federal government must continue to subsidize borrowing by lower-level governments, it could do this with less sacrifice of equity in the tax structure by such devices as direct interest subsidies or tax credits to holders of exempt bonds.

The remaining two chapters in the third part of the report can be discussed briefly. Chapter X, on state and local tax expenditures that benefit the Federal government, discusses such matters as exemption of Federal property from property taxes, the exemption of interest on Federal bonds and social security benefits from state and local income taxation, and so on. Estimates of the level of state and local tax expenditures are presented. This short but useful chapter serves as a complement to the earlier extended treatment of Federal tax expenditures on behalf of lower-level governments, thus helping to complete the picture of the many and complex interactions between the various

levels of government in the United States. Chapter XI considers macroeconomic issues relating to state and local governments. It is particularly concerned with the way that cyclical fluctuations affect state and local expenditures and tax revenues, their possible pro- or anti-cyclical impact, and related issues. It also contains some discussion of recent Federal attempts to cushion state and local governments from cyclical downturns by directing fiscal assistance to them. (The indications here are that such assistance has tended to arrive well after recessionary troughs, thus perversely aggravating rather dampening macroeconomic fluctuations.) In general, the indications from this chapter would seem to be that policy relating to intergovernmental fiscal relations should be based on longer-term structural considerations rather than attempting to address short-term stabilization concerns.

REFORM, PAST AND PRESENT

The last two chapters of the Treasury report deal with the history of efforts to reform Federal-state-local fiscal relations in the United States, and with the prospects for the future. Chapter XII, which covers the history, focuses its discussion primarily on the postwar period. This is indeed a fascinating period, since it encompassed a historically unprecedented expansion in Federal aid to states and localities—one of the major contributing components in the remarkable growth of the Federal government and in the growth of the whole public sector. It emphasizes that the 1960s were a watershed, in that the Johnson administration's Great Society initiatives entailed an enormous proliferation and expansion of intergovernmental grant programs. In many respects, subsequent policy developments can be seen as a series of responses to the developments of the 1960s, as attempts have been made to simplify, consolidate, and ultimately to curtail the distribution of Federal grant aid. There is a very interesting blow-by-blow history of the federalism proposals of the first Reagan Administration, including the famous proposed trade of

AFDC and Food Stamps for Medicaid responsibilities between the Federal government and the states.

Chapter XIII, the final chapter of the report, contains an attempt to project expenditure and revenue levels into the near- to medium-term future for state and local governments. The details of the projections depend, of course, on various assumptions about the overall national economy, the level of public goods to be provided in the years to come, and so on. The report, for example, considers the claim that huge levels of state and local spending will be required to rebuild the nation's public infrastructure. It concludes, in this particular case, that some increases in spending will be necessary to keep the public capital stock from falling further than it has in recent years, but projects expenditure levels less than those that would be necessary to return the capital stock to its previous highest level, which is calculated to have occurred in 1978.

On the basis of these sorts of extrapolations, the report concludes that the "existing tax and spending policies [of states and localities] are sustainable over the long term," that "the fiscal outlook for the States and localities is more favorable today than it has been at virtually any other time in recent history," and that "the State-local sector as a whole is in fundamental equilibrium" (pp. 420-421). By contrast, "the fiscal situation of the Federal government is today in a state of serious disequilibrium" (p. 420). As noted above, the precise meaning of "fiscal equilibrium," as used here, is rather unclear. (Among other things, it seems to rest on the accuracy of projected expenditure and revenue levels for various governments, which in turn rests on projections of future policies, as we have just seen. This is inherently a somewhat speculative business.) In any case, the concept of fiscal equilibrium seems to be used here to suggest that state and local governments should not anticipate significant increases in Federal aid, or that decreases in such aid may be called for.[7] Thus, it appears that the "bottom line" of the Treasury report, in terms of its short- to medium-term policy implications, is that the trend toward reduced Federal transfers to states and localities may be expected to continue.

CRITICS OF THE REPORT

One interesting feature of the legislation that led to the Treasury report is that it required the Treasury to consult with representatives of state and local governments, and to append their comments and views to the final report. The result is approximately 70 pages of letters and reports appearing in the final document, the longest of which is a roughly 30-page contribution by the State and Local Advisory Group (SLAG), whose report was endorsed by nearly 20 organizations such as national and regional associations of counties, cities, governors, and state budget and revenue officers. It is quite interesting to compare the views expressed by various contributors. Certainly one obtains from them an enhanced appreciation of the political forces that are brought to bear in this area of public policy.

For example, both the New England Governors' Conference and the Western Governors' Association endorse the SLAG report, and also include separate reports of their own. The separate reports devote considerable attention to the problem of measuring fiscal capacity, and compare the PI, RTS, and TTR approaches. Both come out in favor of fair and equitable procedures in this important area. According to the western governors, PI is much better than RTS because the latter is biased against energy-producing and low-population states (examples might be Montana, Wyoming, or Alaska) in favor of urban manufacturing states. TTR is a "more constructive" approach, but still "incorporates many biases" (p. 483). The New England governors, on the other hand, favor the RTS approach against PI. According to them, PI misses important revenue sources "that are routinely tapped by many state and local governments" (p. 464), such as severance taxes. The New England report quotes ACIR figures showing that, according to the PI approach, the six New England states have a 1982 fiscal capacity index of 99, compared to 95 for a group of six states using severance taxes. But on the RTS approach, the New England states show a capacity of only 94, whereas the six severance states have a capacity index of 133. The New England governors find that TTR might have some useful features but that it is too difficult to implement as a practical matter.

It appears, therefore, that the western states would receive a higher share of Federal grant aid if it were linked to the PI index that they prefer, while the New England states would take a higher share under their preferred index, the RTS. Indeed, one can easily see how the issue of fiscal capacity measurement could divide representatives of states and localities along regional, urban/rural, agriculture/manufacturing, or other lines.

How is it, then, that not only the western and New England governors, but also the Midwestern governors, came to endorse the SLAG report? In part, no doubt, their endorsement is attributable to the fact that the SLAG report expresses their shared concerns for an approach to fiscal federalism that deals with the issues of "fairness, fiscal disparities, need, and compassion" (p. 429), issues that the Treasury report, by implication, treats less than satisfactorily. In part, perhaps, their endorsement is also attributable to the fact that the SLAG report does not discuss the problem of fiscal capacity measurement. Instead, it focuses on the overall allocation of resources and responsibilities between the Federal government and the states.

For example, the SLAG report emphasizes that states and localities have very small surpluses and have imposed austerity budgets and raised taxes in the face of recession and reductions in Federal aid. It argues that states face large and growing demands for essential public services, and that the Federal government should not impose on states and localities the sole responsibility for income maintenance or other major expenditure functions. It also finds strong arguments for the continuation of state and local tax deductibility and for the continued exemption of state and local bond interest from Federal income taxation. Finally, the SLAG report strongly supports continuation of revenue sharing. One can see here how state and local officials from very diverse constituencies can find common ground in the SLAG report.

Overall, the SLAG report has a very critical tone toward the Treasury report. It explicitly eschews (p. 438) what is referred to as a "market perspective," that is, an approach that, although it may be "academically sound within their [?] own discipline of economics, . . . fails to accommodate political, social, and administrative realities." (Evidently, the Treasury report is guilty of taking such a "market" approach.) Indeed, the "politically based" approach to the issues of fiscal federalism favored by SLAG involves "much more than just winners and losers; it must also concern itself with questions of fairness, risk minimization, precedent, capacities, compromise, and compassion for those who may suffer."

On the basis of statements like this, one is inclined to give the SLAG authors high marks for noble sentiments. However, one also wishes to rise to the defense of the "market perspective," insofar as this is a shorthand term for an attempt, whether successful or not, to justify policy proposals and evaluations by the application of at least rudimentary logical and quantitative analysis. Indeed, in view of the SLAG report's conclusions that the Federal government should maintain or increase all of its major forms of assistance to lower-level governments, the support of the western governors for policies that would direct more assistance to western states, and the support of New England governors for policies that would direct more assistance toward New England, one might surmise that the "compassion" for which the SLAG report so nobly calls is really compassion for state and local government officials who would be faced with difficult budgetary and tax decisions in the face of further cuts in Federal aid. Compared to "politically based" arguments of the caliber found in the SLAG comments, the supposedly unfeeling, uncaring economic approach looks rather attractive. Indeed, perhaps it is by comparison with politically oriented commentary on problems of fiscal federalism that the real value-added of economic analysis of the type embodied in the Treasury report can best be appreciated.

EVALUATION OF THE TREASURY REPORT

In evaluating the Treasury report, it is important to bear in mind that it seems to have been intended from the outset to be a "technical" review of policy issues, rather than a study that conducts possibly controversial *evaluations* of existing or prospective future policies. Indeed, the second paragraph of the report summary states that the report is *"a technical rather than a policy document"* (p. v), and Secretary of the Treasury Baker, in his covering letter to the President, is also very specific that *"this report does not necessarily articulate Treasury or Administration policy—and should not be construed as doing so"* (p. iii) (emphasis in originals). Therefore, we should not be surprised to find that the report is cautious in the extreme about making recommendations for policy changes. In fact, with the exception of the proposal for the use of TTR for fiscal capacity measurement, there are almost no explicit recommendations, with respect to major policies, to be found in the entire report.

In some respects, however, this is rather unfortunate. After hundreds of pages of discussion, one would have liked to see an attempt to integrate and evaluate the report's findings. What lessons are we to draw from the study about the overall direction of intergovernmental fiscal relations in the United States today? What existing policies should be maintained? Which are good candidates for elimination or modification? It would have been very useful to have had, if not a forthright summary of policy recommendations, at least a clearly presented outline of major policy options.

Of course, the report embodies a certain implicit policy agenda in the selection of topics for study and analysis. The discussions of fiscal capacity, state and local tax deductibility, and the interest exemption on state and local debt stand out as examples where the report identifies major potential deficiencies in existing policies and, explicitly or implicitly, suggests reforms. These issues are important ones, and the Treasury report justifiably gives them considerable prominence.

On the other hand, there are many potential topics for policy reform that might have been considered, but were not. For instance, the report might have reexamined the earlier Reagan Administration proposal for the realignment of Federal and state responsibilities for AFDC and Medicaid—a proposal whose merits could have been carefully scrutinized and evaluated here, even if it is politically somewhat passé. Or, as another alternative, several functional categories of expenditure in which the Federal government assists state or local governments might have been singled out for special examination. For example, one could study the rationale for increases or decreases in assistance to states for transportation, health and hospitals, law enforcement, etc. Since many grants are distributed on this basis, it seems reasonable to confront, in a very direct way, the issue of whether and how such categorical fiscal assistance can be justified.

The report might also have tackled more directly the problem of determining the proper overall level of Federal transfers to lower-level governments. Indeed, consider the data presented in Table 1. They tell a simple and interesting story about Federal grants relative to all other Federal expenditures. During the 1960s, Federal grant programs grew enormously. These programs consistently were funded at a high level throughout the 1970s. During the first half of the 1980s, a period during which dramatic political struggles over budget cuts were much in the news, government expenditures for interest, defense, and social security were all increasing, both as a share of GNP and as a share of the Federal budget. All other domestic expenditures, except for aid to lower-level governments, held roughly constant as a share of GNP. The one broad category of expenditure that really did get cut at this time was Federal grant assistance. As a share of GNP, grants fell by over 20% between 1980 and 1983, and as a share of the Federal budget they fell by nearly 30% during the same period. In short, intergovernmental transfers were really at the "cutting edge" of budgetary action in the first Reagan Administration. Insofar as the budget axe fell at all, it fell primarily in this area.

One presumes that it was the political tension engendered by these cuts that led to the congressional directive to the Treasury to prepare its study of intergovernmental fiscal relations in the first place. These budget reductions, and the size and direction of future changes in Federal aid, would have to be near the top of most lists of urgent policy concerns in American fiscal federalism. Indeed, the report, in its discussion of fiscal "equilibrium" for the

TABLE 1

Federal Government Expenditures, Selected Years 1964-1984

Year	Total Federal Expenditure	Net Interest, Defense, and Social Security		Federal Aid to States and Localities		Other Federal Expenditure	
	as % of GNP	as % of GNP	as % of Federal expenditure	as % of GNP	as % of Federal expenditure	as % of GNP	as % of Federal expenditure
1964	18.5	11.5	61.9	1.6	8.8	5.4	29.4
1969	20.0	13.0	65.2	2.2	10.8	4.8	23.9
1974	20.9	11.8	56.7	3.1	14.7	6.0	28.6
1978	21.3	11.7	55.1	3.6	16.8	6.0	28.1
1980	22.9	13.0	57.0	3.4	14.5	6.5	28.5
1981	23.3	14.0	60.0	2.9	12.5	6.4	27.4
1982	24.9	15.4	61.9	2.7	10.7	6.8	27.4
1983	24.8	15.8	63.6	2.6	10.3	6.5	26.1
1984	24.0	15.9	66.0	2.5	10.6	5.6	23.5

SOURCE: ACIR (1986).

states and localities, and "disequilibrium" for the Federal government, does indirectly address this issue. However, the report offers little explicit analysis of the benefits and costs of recent policy. Should Federal aid be maintained at existing levels? Should it be increased or decreased? What can be said in favor of or against each of these options? These are major policy questions that deserve consideration. It is unfortunate that the opportunity to confront them directly has been missed—unfortunate, but in view of the legislative mandate, perhaps understandable.

Since the Treasury study is supposed to be "technical" in nature, let us now consider it from that perspective. First, as should be clear from the preceding overview, the report breaks little new ground, at least in terms of the economics of fiscal federalism. A great deal of the material in the report has already been available for many years in such well-known references as Oates (1972), Break (1980), or Aronson and Hilley (1986) (formerly published by Maxwell and Aronson in 1977 and by Maxwell in 1965 and 1969), not to mention more specialized sources such as the professional journals. Its discussion of economic issues is, however, consistently quite competent and generally thorough. In many instances—for example, in the treatment of the impact of grants on recipient government spending or in the discussion of the incentives arising from deductibility of state and local taxes and the exemption of state and local bond interest—the report correctly applies economic analysis to draw inferences about the effects of different policies that would not always be apparent to noneconomists. Thus, one must conclude that there is much solid economic content in this report.

Naturally there are gaps in coverage. The implication of alternative Federal policies for the spatial allocation of resources in general does not get as much attention as it deserves. I am thinking here, for example, of the effect of grants on household and firm locational choice. In an era when regional issues such as migration from the frostbelt to the sunbelt or from Mexico to the United States present many important problems for state and local governments, this omission is significant. Similarly, the treatment of tax competition and tax exporting is sometimes a bit sketchy. There is a fairly extensive discussion of tax exporting in connection with the measurement of fiscal capacity, where it is argued that the base of any exported taxes should be part of the TTR for a jurisdiction. However, there is little attempt made to evaluate the quantitative importance of exporting or its impact on public spending or the distribution of income. The question of coordination of the tax treatment of corporations among states and localities gets little attention, as does the question of taxation of natural resources. More generally, it would have been useful to have had some discussion of the extent to which state and local government fiscal and regulatory policies inhibit or promote the free flow of commerce with the United States. These are all aspects of intergovernmental fiscal relations that are relevant from the perspective of Federal government policymaking. For example, there might be Federal policies that could aim directly at state and local government practices that entail fiscal discrimination against nonresidents. Moreover, even if there is no feasible Federal policy that could directly affect interactions such as tax competition among the states, these sorts of fiscal interactions could still be relevant for Federal policies that might impinge on them indirectly. How should grant policy be affected, for example, if there is significant fiscal competition among lower-level governments? Another area that gets relatively little coverage in the Treasury report is the impact of Federal, state, and local taxes on the distribution of income. For example, it is somewhat surprising to find almost no discussion of the incidence of the property tax, or of the relative burdens, for labor and capital, of state sales, personal income, or corporate income. Since one major effect of Federal grants is the substitution of Federal for state financing of public expenditure, a discussion of Federal-state tax substitution would have been useful. Of course, discussion of the efficiency implications of such substitution would have been quite relevant as well.

How important are the omissions in the Treasury report? In some cases, they are substantial. For example, there is a relatively well-developed literature on property taxation. There are both theoretical insights and empirical findings in this literature that

are relevant for the overall assessment of intergovernmental fiscal relations in the United States. Similarly, there is an extensive literature on the effects of lower-level government taxes and spending on migration of households and firms (see, e.g., Wildasin [forthcoming] for references) that could have been exploited for the purposes of this study. On the other hand, the literature in other areas (such as tax competition) has been much more limited (at least until quite recently), so that, despite the possible importance of certain topics, there was relatively little that the report could offer by way of a review or application of major published findings.

In summary, then, it seems to me that the Treasury report should be applauded by economists for its role in putting many of the most important insights from the economics of fiscal federalism at center stage. In some respects, its coverage of the field could have been more comprehensive and up to date. However, one must remember the limitations of the field itself. There are many problems that are important for policy that have not yet been investigated adequately. Professional economists can draw inspiration for their research from a critical reading of the Treasury report. Certainly the potential for economic analysis to contribute to better understanding of policy alternatives in this area is enormous. It is to be hoped that the next major government report on intergovernmental fiscal relations will have a much more fully developed base of theoretical and empirical economic research on which to draw.

NOTES

1. *Federal-State-Local Fiscal Relations: Report to the President and Congress*, Office of State and Local Finance, Department of the Treasury, pp. lv, 494. (Washington, D.C., 1985: Government Printing Office.)

2. It should be noted that the presentation of statistical data in the Treasury report follows standard accounting procedures. This is probably to be expected, but it does mean that these data, and the discussion based on them, are subject to the usual limitations. For example, the data on indebtedness alone do not provide a very comprehensive picture of changes in the net worth of governments, since they ignore underfunded pension liabilities

of state and local governments, not to mention underfunded liabilities of the Federal Social Security system. These and other complications are not mere technicalities. On the contrary, they have major implications for the measurement of the fiscal position of governments at all levels.

3. For example, much of the statistical information could be found in publications such as the *Census of Governments* and the *Government Finances* series issued by the Bureau of the Census or the *Significant Features of Fiscal Federalism* series issued by the ACIR.

4. It should be noted that there is an obvious fallacy underlying this conclusion. Almost any small program (small, for example, relative to GNP) will have small effects on the national economy. That does not mean that these effects can be safely ignored in evaluating the program, however. What matters is the impact of the program relative to *its* size, not relative to the whole economy.

5. See ACIR (1986a, 1986b).

6. Of course, underlying the notion that deductibility leads to more progressive state and local taxes is the notion that there is some limit to the net burden that lower level governments are willing or able to impose on their high-income residents. To the extent that this constraint is operative, deductibility may simply increase the apparent statutory progressivity of the overall tax structure without changing the real distribution of tax burdens. That is, the distributional effects of more progressive state and local taxes may simply be undone by the Federal offset.

7. This implication, indeed, is not stated plainly in the report. However, it is the inference drawn by the state and local government representatives who were asked to comment on the report.

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David E. Wildasin is a Professor of Economics at Indiana University. He was a Research Associate at the Center for Operations Research and Econometrics, and a Visiting Professor of Economics at the Universite Catholique de Louvain when this paper was written.