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Changing Federalism: Trends and Interstate Variations
Roy Bahl

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Every administration brings a new federalism with it. Most of the fanfare surrounds the announced programs that redefine the public financing roles of the federal, state, and local governments. The Johnson administration promoted poverty programs and Nixon's adopted General Revenue Sharing. Carter's bypassed the state governments in creating the big, direct, urban aid programs-CETA, ARFA, and local public works- and later began the retrenchment in federal aid to state and local governments and grant consolidation. The Reagan administration made bigger inroads into grant consolidation, continued the grant retrenchment, cut away at the deductibility subsidy to state and local governments, and shifted the balance of fiscal power back to the state level by abolishing direct local aid and the remnants of general revenue sharing.

Such announced changes, however, are only part of the story of what brings about changes in American intergovernmental structure, and possibly not even the most important part. Federal macroeconomic policies, designed to influence other aspects of economic and fiscal performance, may have an even stronger impact. The 1986 federal tax reform will have a profound effect on federal-state-local fiscal balance. Moreover, the reaction by state and local governments to federal policies is shaped by the performance of the U.S. economy. For example, the Carter urban-aid initiatives were enacted in the high inflation/recession years of the mid-1970s and were played out during the time of Propositions 13 and 2½. Surely the state and local government response would have been different if these same programs had been enacted in the more favorable economic climate of the Reagan years.

This paper attempts to describe and explain the changing American federalism of the past two decades, taking both the intended and the unintended impacts into account. In the next two sections we describe the basic trends in intergovernmental finance over the past twenty-five years and the changes in the interstate variations in these trends. In the third section, we tum to the question of whether and how these changes might have enhanced or compromised the fiscal condition of state and local governments. The final section speculates about what might become the Bush version of federalism and the changes it could bring during the rest of this century.

Trends in Intergovernmental Finance[1]

The development of the U.S. public sector between 1942 and 1976 can be characterized by three major trends: a growing importance of the federal government sector in the U.S. economy; a shift in public spending toward health, education, and welfare services; and a long-term trend of increase in state and local government dependence on federal intergovernmental transfers.[2] During the past decade, all three of these long term trends have been either bent or reversed.

Growth in the State and Local Government Sector

A reasonable place to begin is to ask whether the state and local government sector has been growing, both relative to the size of the federal sector and as a component of the U.S. economy. By the two most commonly used indicators of government activity-employment and expenditures-it has, at least in recent years. If a public employment benchmark is used, state and local governments have dominated the growth in the public sector in the past twenty years. Public employment may not be an appropriate comparative, however, because the functions of the state and local government sector make it quite labor intensive whereas transfers, debt repayment, capital outlays, and other nonlabor expenditures are much more important at the federal level. Total expenditure, therefore, is probably a better indicator of the relative growth of the state and local sector.

Table 4.1

Government Domestic Expenditure

Calendar year	Federal[a]	State[b]	Local[c]	Federal[a]	State[b]	Local[c]
	Percent of total domestic public sector			Percent of GNP		
From own funds						
1954	46.7	24.9	28.2	6.5	3.4	3.9
1964	51.0	23.6	25.3	9.4	4.3	4.6
1974	55.4	25.0	19.5	13.7	6.2	4.8
1981	60.4	23.1	16.5	15.1	5.8	4.1
1982	60.3	23.0	16.7	15.9	6.0	4.4
1983	59.8	22.9	17.3	15.4	5.9	4.5
1984	59.0	23.1	17.9	14.5	5.7	4.4
1985	58.8	23.5	17.7	14.9	6.0	4.4
1986	57.5	24.8	17.7	14.6	6.3	4.5
1987	**55.3**	25.8	18.9	13.9	6.5	4.8
After intergovernmental transfers[c]						
1954	41.1	20.8	37.7	5.7	2.9	5.2
1964	42.3	20.0	37.6	7.8	3.7	6.9
1974	43.4	21.1	35.5	10.8	5.2	8.8
1981	48.9	20.1	31.0	12.3	5.0	7.8
1982	50.2	19.6	30.1	13.2	5.2	7.9
1983	50.0	19.7	30.3	12.9	5.1	7.8
1984	48.9	20.3	30.8	12.0	5.0	7.6
1985	48.9	20.7	30.4	12.4	5.2	7.7
1986	47.8	21.1	31.1	12.1	5.4	7.9
1987	46.4	21.7	31.9	11.7	5.5	8.1

Source: Summarized from various tables in Advisory Committee on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1981-82 and 1989 editions (Washington, DC: U.S. Government

Printing Office).
[a] Excludes federal expenditure for national defense, international affairs and finance, and space research and technology, and the estimated portion of net interest attributable to these functions. Includes Social Security (OASDHI) and all federal aid to state and local governments, including general revenue sharing payments.
[b] The National Income and Product Accounts do not report state and local government data separately. The state and local expenditure totals (National Income Accounts) were allocated between levels of government on the basis of ratios (by year) reported by the United States Bureau of the Census in the government finance series.
[c] All federal aid to state and local governments, including general revenue sharing payments, is included as state and local expenditure and excluded from federal domestic expenditure.

There has been no change in the long term trend of a growing importance of subnational governments in the national economy. The state and local government expenditure share of GNP has increased significantly in the past thirty years. There was a hiatus in this growing claim on resources in the early 1980s, but by 1987 the share of GNP had reached 11.3 percent, approximately the level it had reached before Proposition 13 in 1978. The story is somewhat different for the state and local government share of total government expenditures. Federal government domestic expenditures accounted for an increasing share of total public sector activity from the early 1950s until the early 1980s (Table 4.1). Even if defense expenditures are excluded from the computation and intergovernmental transfers are counted as state and local government expenditures, this conclusion holds true.

This pattern was reversed in the 1980s, and the state and local government share of public expenditures (after transfers) has risen from 49.7 percent in 1982 to 53.6 percent in 1987. The break in the general pattern that seems to have occurred in recent years is an important turnaround, especially in light of how the tax limitation movement of the late 1970s suppressed tax increases by state and local governments. The Advisory Commission on Intergovernmental Relations (ACIR) estimated that none of the $30 billion in real state-tax increase during 1976-80 was due to political actions,[3] and the ratio of state and local government taxes to personal income fell from 12.8 percent in 1977 to 11.6 percent in 1982. Beginning with a 1983 round of state government tax increases, largely in response to the economic slowdown and federal aid reductions during 1981-83, the growth in s pending and revenue raising shifted back to the state and local government sector and the average rate of taxation increased. Though the level of state and local government taxes still has not risen past its 1978 level, the turnaround in its revenue raising efforts is impressive. Though the federal government is nearly twice as large in terms of tax collections, state and local governments have accounted for half of all tax collections since 1980.[4]

There are a number of possible explanations for this stronger state and local government fiscal performance: the discretionary response to federal aid cutbacks and the retrenchment in federal domestic programs, the unleashing of public sector demands that were held in check during the limitation years, and the combination of the natural buoyancy of state government revenue systems and the strong performance of the economy.

Increased Social Welfare Expenditures

A second dominant trend in the U.S.fiscal system has been the continuing increase in the budget claim of health, education, and welfare expenditures. The postwar increase in public expenditures at all levels of government, as well as the shift toward an increasing federal share, has been largely due to increased social welfare expenditures.[5]

Table 4.2

Sources of Growth in Federal Domestic Expenditures

	Percent distribution of social welfare expenditures			Percent of GNP		
Calendar year	Social Security (OASDHI)[a]	Federal aid[b]	All other[c]	Social Security (OASDHI)[a]	Federal aid[b]	All other[c]
1954	15.4	11.7	72.9	1.0	0.8	4.7
1964	27.1	16.6	56.3	2.5	1.6	5.3
1974	35.8	21.5	42.7	4.9	2.9	5.9
1981	40.2	18.7	41.1	6.1	2.8	6.2
1982	41.6	16.4	42.0	6.6	2.6	6.7
1983	42.9	16.1	41.0	6.6	2.5	6.3
1984	44.1	16.8	39.0	6.4	2.4	5.6
1985	43.4	16.4	40.2	6.4	2.4	6.0
1986	44.3	16.8	38.9	6.5	2.5	5.7
1987	45.4	15.7	38.8	6.4	2.2	5.5

Source: Summarized from Advisory Commission on Intergovernmental Relations (ACIR), Significant Features, 1981-82, and 1989 editions, various tables.
[a] National Income and Product Account.
[b] Federal aid as reported in the National Income Accounts (used here) differs slightly from the federal payments (census) series (used in Table 4.3). The major difference is the inclusion of federal payments for low-rent public housing (estimated at $3.5 billion in 1980) in the census series but excluded by definition from the NIA series. Federal general revenue sharing is included in both series.
[c] Includes direct federal expenditure for education, public assistance and relief, veterans benefits and services, commerce, transportation, and housing, and others.

At the federal level, the expenditure increases of the 1960s and 1970s were dominated by Social Security expenditures and grants to state and local governments (Table 4.2). The Social Security share of federal domes- tic expenditures more than doubled between 1954 and 1980, and the amount of federal aid to state and local governments doubled between 1954 and 1978, increasing as a share of federal domestic expenditures from 11.7 percent in 1954 to 18.7 percent in 1981. Moreover, there was a marked shift toward social welfare services in the composition of this federal aid.

Again, there would appear to be a structural break in recent years. Assistance to state and local governments as a share of the total federal budget has been declining since 1978 and though the Social

Security share of expenditures has not fallen, its share of GNP has not increased. As a share of GNP, social welfare expenditures were lower in 1987 than they were in 1981.

The reversal has been much more dramatic at the state and local government level. About 60 percent of the expenditure increase during the 1960-76 period was for health, education, and welfare purposes, but this share fell to 56 percent between 1976 and 1981. Put another way, the average 1 percent increase in GNP between 1960 and 1976 generated a 1.56 percent increase in social welfare expenditures. Between 1976 and 1981, this income elasticity of social welfare expenditures was only 0.84. During the 1982-86 growth period, the average 1 percent increase in personal income was associated with only a 0.95 percent increase in health, education, and welfare expenditures by state and local governments. The implications of these elasticities are not as clear as one would like. One explanation is that federal assistance to state and local governments and direct federal expenditures for health, education, and welfare purposes, have been cut. On average, state and local governments have responded relatively more by passing these cuts along to beneficiaries than by, raising taxes or redirecting expenditures from other areas.

·However, the fact is that state and local governments did raise revenues during this period by enough to offset the federal aid reductions. Another explanation, then, is that citizens were demanding a reduction in the share of their personal income spent on social welfare activities. However, there is much variation in this pattern and it is difficult to isolate a clear national pattern.[6]

Federal Aid Dependence

The third major trend of the past two decades has been the growing importance of federal aid flows in the public sector. For every 1 percent increase in GNP between 1954 and 1976, federal general revenues (including Social Security) grew by about 1 percent, state and local government revenues from own sources by about 2 percent, and federal aid by about 5 percent. With this trend came a growing reliance by state and local governments on federal aid. By 1978, federal aid accounted for 22 percent of total state and local government revenue and was a more important financing source than any of the property, sales, or income taxes (Table 4.3).

Since the late 1970s, federal grants declined in importance as a financing source for state and local governments, reversing a two-decade trend of increase. The National Income Accounts (NIA) show that at the end of 1987 the federal financing share had fallen to 16.6 percent of state and local government revenues.[7] By 1987, state and local governments were raising as much from the property tax as they were receiving in federal aid (Table 4.3).

Table 4.3

Reliance of State and Local Government on Federal Aid and Major Tax Revenue Sources

	Percent of total general revenue			
Year	Federal aid	Property taxes	Income taxes	Sales taxesa
1954	10.3	34.4	6.6	25.1
1964	14.7	31.0	8.0	23.1
1974	20.1	23.0	12.3	22.2
1976	21.7	22.3	12.3	21.3
1977	21.9	21.9	13.4	21.2
1978	22.0	21.0	13.9	21.4
1979	21.8	18.9	14.3	21.6
1980	21.7	17.9	14.5	20.9
1981	21.3	17.7	14.3	20.3
1982	19.1	18.0	14.4	20.5
1983	18.5	18.3	14.3	20.6
1984	17.9	17.8	15.0	21.0
1985	17.8	17.4	14.9	21.1
1986	17.6	17.4	14.7	21.0
1987	16.6	17.7	15.5	21.0

Source: U.S. Bureau of the Census, Governmental Finances, Series GF No. 5 (Washington, DC: U.S. Government Printing Office, various years).
[a] Includes general and selective sales taxes.

Increasing Centralization

Accompanying these three important trends has been a growing dominance of state government within the state and local sector. The state government share of total taxes collected rose from 57 to 65 percent between 1967 and 1982, though the states' share of direct expenditures remained approximately constant during this period (see Table 4.4).[8]

There are a number of explanations for this trend. One-widely believed, but not supported by these data-is that state government income and sales taxes are more buoyant than local property taxes, and there was a substantial growth in real income. Another is that state governments increased assistance to locally provided services in some cases, and directly assumed service responsibilities in others, largely to forestall politically unpopular increases in the effective rate of property taxation. Yet another possibility is that the states were better able to look after themselves with discretionary changes in sales and income tax rates than were local governments who had to rely on the property tax-an- other manifestation of John Shannon's ''fend-for-yourself federalism.'' Whatever the reason, this trend was interrupted in the 1980s and there has been no significant change in the state government share of taxes. It is important to note that these are aggregate data and describe the importance of state vs. local

Table 4.4

Indicators of Fiscal Importance: Means and Interstate Variation

	Total expenditures as percent of state personal income				**Federal aid as percent of personal income**				**Revenues from own source as percent of personal income**				**State government percent of direct expenditures**				**State government percent of tax revenues**			
	1967	**1977**	**1982**	**1987**	**1967**	**1977**	**1982**	**1987**	**1967**	**1977**	**1982**	**1987**	**1967**	**1977**	**1982**	**1967**	**1967**	**1977**	**1982**	**1987**
Mean	18.6	18.6	21.3	22.5	3.4	4.6	3.7	3.5	12.7	14.7	16.0	16.6	44.3	44.4	45.0	45.8	56.8	62.4	64.5	63.8
Coefficient of Variation	0.21	0.16	0.25	.031	.062	.026	0.25	0.31	0.14	0.18	0.59	0.36	0.23	0.21	0.20	0.19	0.20	0.17	0.16	0.15

Source: U.S. Bureau of the Census, Governmental Finances (Washington, DC: U.S. Government Printing Office, various years).

government as sectors of the economy. As we show below, wide interstate variations lie beneath this average behavior.

Interstate Variations

The data in Tables 4.1-4.4 tell a story that the pattern of intergovernmental finance has changed in the 1980s. Some longstanding trends-most notably the growing importance of the state and local government sector in the economy-have continued. Other trends have been broken in the 1980s suggesting some very important changes in the system. The responsibility for revenue raising has shifted from the federal to the state-local sector but within the state-local sector the strong trend toward state fiscal centralization may have stopped. Revenue effort by state and local governments has increased since the early 1980s to make up for federal aid reductions, and there has been a shift away from spending for social services at all levels of government. As may be seen from Table 4.4, there is a trend toward uniformity among the states in some of these trends, e.g., increased state responsibility for expenditures and revenue raising, but much less uniformity in most of the other dimensions of fiscal change reported.[9] This suggests the need to examine more closely the interstate variations in fiscal performance.

Five dimensions of the interstate variation are considered here: (a) the increasing fiscal centralization to the state government level, (b) changes in the rate of revenue mobilization, (c) the declines in federal aid, (d) the determinants of variations in state and local government expenditures, and (e) the changing structure of state and local government revenues and expenditures.

Fiscal Centralization

As reported in Tables 4.1 and 4.4, the 1980s have seen a shift in revenue raising power to the state and local government level but an interruption of the growing fiscal dominance of state governments. Average tax revenue centralization in the 1967-77 period increased substantially (Table 4.4) and most states centralized their revenue systems (Table 4.5). The 1977-87 period again shows more states centralizing than decentralizing their revenue-raising powers, but during this period there was no increase in the aggregate share of taxes collected at the state government level. It is significant to note, however, that only five states increased the share of own-source revenues raised at the local level during the 1977-87 period. The trend toward centralization is less evident on the expenditure side during the 1967-77 period. The average state

government share of expenditures rose only slightly and twenty-five states centralized their expenditure responsibility while only twelve decentralized. Though there was no appreciable change in the aggregate state-local expenditure share between 1977 and 1987, twenty-three states decentralized while only fourteen centralized.

Revenue Mobilization

On average, state and local government revenues raised from own sources increased from 14.7 percent of personal income in 1977 to 16.6 percent in 1987 (Table 4.6). However, when Alaska is removed from the comparison, there appears to have been little increase in the average state and local government revenue burden over the past decade. There have, however, been substantial interstate variations in revenue mobilization, and the question we raise here is the extent to which these trends are uniform and the kinds of states that have gone with and against the trend. There was no significant correlation between the revenue mobilization ratio and per-capita income in 1967 or in 1987, but in 1977 (immediately after the recession) high-income states were mobilizing a significantly greater revenue share. This finding for the post-1975 recession period is consistent with the Advisory Commission on Intergovernmental Relations' (ACIR) observation that states experiencing fiscal stress will be the ones who increase tax effort,[10] and with the fact that many higher income states were hardest hit by that recession. The 1980s, Gold and Zelio note, has been more of a case of low taxing (and lower income) states catching up.[11] In all years, however, states which mobilized a greater share of personal income in revenues received a significantly greater level of per capita federal grants. States in all four census regions, on average, moved with this general trend.

Table 4.5

Trends in Fiscal Centralization in State and Local Government

	Number of states with		
	Increased centralization	Increased decentralization	No change
Revenues			
1967-77	26	13	11
1977-87	27	7	16
Expenditures			
1967-77	25	14	11
1977-87	14	23	13

[a] *Increased fiscal centralization* is defined as an increase in the ratio of state to state and local government revenues raised from own sources of more than two percentage points. *Decentralization* refers to a decline of more than two percentage points. *Expenditure decentralization* is defined in an analogous way.

Declining Federal Aid

A policy event of major importance in the late 1970s and early 1980s has been the substantial slowing of growth in federal grants to state and local governments. Inflation-adjusted federal grant revenues fell from $49.4 billion in 1978 to an estimated $37.7 billion in 1987; from 3.7 to 2.2 percent of GNP. The result is that state and local governments have become much less dependent on federal aid: from 22 percent of total general revenues in 1978, federal assistance dropped below 17 percent in 1987 (Table4.3).

Table 4.6 Revenue Mobilization			
	1967	**1977**	**1987**
Revenue Share[a]			
Average	12.7	14.7	16.6
Range	7.8	16.3	41.3
Highest	17.3 (ND)	20.6 (NY)[b]	31.7 (WY)[b]
Lowest	9.6 (IL)	11.7 (MO)	11.66 (NH)
Regional average revenue shares			
North	11.4	15.0	15.0
South	12.1	13.3	15.0
Midwest	12.7	14.5	15.4
West	14.5	16.6	20.7
Correlations with revenue share			
Per capita income			
Per capita federal grants			

[a] Revenue from own sources as a percentage of personal income.
[b] Excluding Alaska, which ranked first.

In real terms, per capita federal aid did not grow at all over the 1977-87 period, by comparison with an average increase of $112 be- tween 1967 and 1977 (see Table4.7). The federal aid declines of the last decade were widespread, taking place in twenty-two states.

Is there a pattern to the retrenchment in federal aid? As may be seen in Table4.7, there is no significant correlation between changes in real per capita federal aid and changes in real per capita income

Table 4.7 Trends in Federal Assistance		
	1967-77	**1977-87**
Change in per capita federal aid		
In current dollars	152	180
In real 1982 dollars	112	0
Regional averages (in real 1982 dollars		
North	190	29
South	108	6
Midwest	120	30
West	57	-54
Number of states with real declines	4	22
Correlation of change in per capita federal aid with change in per capita income	0.629	0.024

between 1977 and 1987. However, this is different from the situation in the previous decade. In the 1967-77 period, states which experienced greater increases in per capita income experienced greater increases in per capita federal aid. At the margin, the system was counter equalizing.

It may be instructive to point out how some states escaped the most severe consequences of the federal aid retrenchment. New York state, for example, has suffered less than much of the rest of the nation[12]. For all New York state and local governments combined, the share of total U.S. federal aid rose from 10.1 percent in 1970 to 11.3 percent in 1984, despite the fact that New York's per capita income level has remained above average and its share of national population has declined. New York City's share of total direct federal aid to local governments also increased, from 6 .1 to 7.2 percent over the same period. Since 1980, the rate of increase in real federal aid to New York state and local governments also has been above the national average. While real federal aid declined nationally, it actually increased in New York. There was a real decline in New York City, but it was only about one-third of that for all local governments in the nation. As a result of this pattern, the dependency of New York state and local governments on federal grants rose above the national average. New York City's dependency is down from a high of 7.9 percent of general revenues in 1980, but has been increasing since 1982.

The composition of federal aid to the New York state government has continued to change markedly toward public welfare: such aid accounted for 69 percent of the total in 1984 versus 57 percent in 1980. (The comparable figures for the U.S. are 47 percent and 40 percent.) In fact, New York State received nearly 17 percent of all federal aid for public welfare. By contrast, highway and education aid are declining in real terms in New York, and the state's national shares are down markedly. In sum, New York's governments have avoided some of the consequences of federal aid retrenchment because of their claims on federal welfare spending. Will this continue? If not, will the state and city make up for the revenue loss? In all likelihood, real reductions in aid will continue as the federal government ''offloads'' part of its deficit on to state and local government. Proposed welfare reforms almost certainly would reinforce this trend. Finally, it is doubtful that a state with a per capita income 14 percent above the national average and a population equivalent to about 7.5 percent of the national population can sustain an 11.4 percent share of total federal aid. Sooner or later there will be pressure to bring the New York share into line with its population share and its financial capacity. Future declines in population share, and thus in New York's congressional representation, are important considerations in this regard.

Expenditure Determinants

State and local government per capita expenditures in 1986 vary from highs (excluding Alaska) of $4,966 and $4,324 in Wyoming and New York, to lows of $2,085 and $2,165 in Arkansas and Missouri. Public-policy analysts have long been interested in the study of determinants of this variation, and much empirical and theoretical work has been done.[13] The results of the empirical studies tend to square with economic theory and a significant portion of the interstate variation in per capita expenditures can be explained.

In this paper, no attempt is made to develop a new theoretical model. Rather, we want to answer two simple questions: (a) to what extent are interstate variations in the level of per capita expenditures associated with differences in per capita income, population, and land area and how has this relationship changed over the years; and (b) has the relationship between per capita federal grants and per capita expenditures, holding constant income, population, and land area, changed in the past two decades?

Table 4.8

Ordinary Least Squares Estimates of the Determinants of Per Capita State and Local Government Expenditures

	Without federal grants	With federal grants	Without federal grants	With federal grants	Without federal grants	With federal grants
Constant	-277.0179 (2.13)	-95.7313 (1.20)	-555.3443 (1.76)	-952.1954 (5.62)	-695.3042 (1.44)	-2,056.9587 (7.10)
Per capita income	0.2182 (16.11)	0.1231 (9.44)	0.2356 (7.04)	0.1716 (9.28)	0.2098 (6.10)	0.1804 (9.61)
Population	-0.0324 (3.59)	0.0060 (0.89)	-0.0230 (2.45)	0.0013 (0.23)	-0.0587 (3.73)	-0.0328 (3.71)
Land area	0.0017 (3.68)	-0.0004 (1.23)	0.0023 (4.29)	0.0007 (2.24)	0.0104 (11.49)	0.0073 (12.87)
Per capita federal grants	--	2.2561 (9.25)	--	2.2809 (11.04)	--	4.4685 (10.61)
R^2	0.84	0.94	0.71	0.92	0.77	0.93

[a] t-statistic shown in parentheses below the regression coefficent.

The results of a regression analysis, designed to answer these questions, are presented in Table 4.8. The response of per capita expenditures to per capita income is positive and significant in all years and the regression coefficients are remarkably stable. Land area shows a positive coefficient reflecting the higher cost of serving a more dispersed population and the high fixed cost of providing certain services. The coefficients are significant in all years. Population size is negatively related to per capita expenditures, holding constant land area and income, suggesting that larger urban agglomerations, *ceteris paribus*, may offer some economies of size. There is little change in the population regression coefficients over this time period. In short, the determinants of interstate variations in public expenditures have not changed much over the past twenty years.

In a second set of equations, federal aid has been added as a right side variable. The relationship with per capita expenditures is positive and significant, and the coefficient is larger in 1987 than in 1967. The hazards of such estimation with ordinary least squares (OLS) are widely known: a least squares bias since the dependent variable may be a determinant of the level of grants received, a specification error in the overall equation since many variables other than income, population, and land determine expenditure levels, and multicollinearity between the grant and other explanatory variables. Even so, many have argued that OLS estimates do give a reasonable approximation of the association between grants and expenditure. These results do not suggest that the stimulative impact of grants is any smaller in the 1980s than it was in the 1970s. States that receive larger amounts of federal grants, on average, spend significantly more.

The Structure of Revenue and Expenditures

There have been decided shifts in the structure of revenues and expenditures. In the past decade federal grants have declined in importance as a financing source and local revenues have increased to pick up some of the shortfall (Table 4.9). However, all state and local government revenues did not increase to the same degree. In fact, revenues from the traditional broad-based state and local government taxes declined from

9.6 percent of GNP in 1978 to 8.8 percent in 1986. The real increase in state and local government revenues has come from a mixture of selective sales taxes, user charges, lotteries, interest income, royalties, and a broad assortment of licenses. In terms of the change in the mix of taxes, there were some consistencies among the states. It is interesting to note that no state increased its property tax share of total revenues or its federal aid share of total revenues between 1977 and 1987.

During this same period, there was a significant change in the distribution of state and local government expenditure budgets across functions. Between 1967 and 1977, thirty-four states increased their budget share on education and as a result about 1.7 cents more of every revenue dollar went for education. Since 1977, no state has increased its share of expenditures for education and about 8 cents less of each revenue dollar is now spent on education. The average shares spent on health, welfare, and highways also dropped in the 1977-87 period and relatively few states moved against this trend.

State Aid to Local, Governments

State intergovernmental expenditures increased to a new high in 1987, $141 billion, compared to $132 billion in 1986 and$108 billion in 1984.[14] As a percentage of state government general expenditure, state intergovernmental payments have remained approximately constant at about 35 percent in the 1980s. However, as a percent of total state and local government expenditure, state aid has declined in the 1980s (Table 4.9). The average per capita amount of state aid was $583 in 1987, with thirty-nine states falling between $350 and $800. Two states spent more than $1,000 per capita in state aid payments: Alaska ($1,785) and Wyoming ($1,122). Hawaii has per capita aid payments of $40 and New Hampshire $172. These variations reflect different choices in terms of the assignment of responsibility to state vs. local governments, rather than any underfinancing or overfinancing of the local government sector. For example, the low per capita aid figure in Hawaii is mostly a reflection of state government operation of the local education system.

Table 4.9
Changing Revenue and Expenditure Composition

	1967	1977	Number of states with increasing shares 1967-77	1987	Number of states with increasing shares 1977-87
Percent of own source general revenues					
Property tax	31.7	26.0	3	20.6	0
Sales tax	27.3	16.3	1	16.4	25
Income tax	7.2	15.0	46	15.7	28
Federal aid	26.2	31.3	43	21.7	0
Other	33.7	42.6	48	47.3	41
State aid as a percent of total state and local government expenditure	15.1	19.0	44	15.6	6
Percent of expenditures					
Education	37.1	38.8	34	30.8	0
Welfare	7.3	10.6	46	9.6	13
Health	5.6	8.0	45	7.0	12
Highways	16.4	11.0	0	8.2	6
Other	33.6	31.6	18	44.4	50

Education still receives by far the greatest share of state aid to local governments (about 62 percent) and welfare is second with 12 percent. However, nine states administer their welfare programs directly so no major welfare aid payments are made by these states to local governments. Both the education and welfare shares of state aid have remained approximately constant in the 1980s. General local government support received 10 percent of total 1987 state aid payments and this share has been fairly constant since 1978, as has the 4.8 percent of all state aid allocated to highways.

Fiscal Conditions[15]

This reading of the data brings us to the conclusion that the state and local government sector is being pushed to a position of greater fiscal self-sufficiency and the governments have responded by increasing their rate of revenue mobilization, and by changing the orientation of their budgets and methods of financing. Does this reaction give rise to a new fiscal strength or to a fiscal weakness in the state and local government sector? Does the unevenness in the response of state and local governments suggest that the fiscal condition of certain types of governments has been compromised by federal policy?

The most used (and oftentimes the most misused) measure of fiscal condition is the general surplus of state and local governments as reported in the National Income Accounts (NIA). An increase in the surplus-a measure of the excess of current revenues over total expenditures (excluding social insurance funds}---may result because of economic growth or increased government efficiency, but one may also reach a larger surplus by raising taxes to exorbitant levels, carrying larger cash balances, reducing essential expenditure or deferring infrastructure maintenance.[16] Still, the general surplus probably does indicate how state and local governments adjust their budgetary policies in response to the economic environment and provides some indirect evidence about whether there has been a change in state and local government policy in the 1980s. Our specific questions are whether the size of the surplus, the determinants of its variation and its cyclical sensitivity are different in the 1980s as compared with the 1970s.

The large surplus in recent years, as reported in Table 4.10, is seen by some as indication of an unusually strong fiscal position of state and local governments. There was a positive general account surplus from the second quarter of 1983 until the fourth quarter of 1986. During this period, the surplus averaged $13.9 billion (in constant 1982 dollars) and 2.8 percent of state and local government expenditures. A surplus of this magnitude suggests that state and local governments had ample discretionary funds with which to support public service levels and to compensate for the loss of federal funds. The question arises as to whether the size of this surplus is abnormally large by comparison with the 1970s, whether it has been less cyclical, and whether the determinants of variations in its size were different in the 1980s.

In fact, the maximum level of the surplus in the 1980s, relative to either total state and local government expenditures or to GNP, has not exceeded the high levels achieved during expansion periods in the 1970s. What is different is that state and local governments have maintained large surpluses over longer periods of time in the 1980s.

Table 4.10
General Account Surplus of State and Local Government Trends and Cyclical Swing

Year: quarter	(peak/trough)[a]	Amount(billions, 1982 dollars)[b]	Percent of total expenditures
1970:IV	(trough)	-18.7	-5.32
1972:IV	(peak)	28.6	7.57
1975:I	(trough)	-20.2	-5.07
1977:III	(peak)	19.5	4.73
1980:II	(trough)	-4.0	-0.95
1981:III	(peak)	6.5	1.55
1983:I	(trough)	-3.9	-0.93
1984:II	(peak)	21.1	4.90
1988:II		-9.0	-1.79

	Cyclical swing (in billions)		Net accumulation (in billions)	
Cycle[c]	**Current dollars**	**1982 dollars[b]**	**Current dollars**	**1982 dollars[b]**
1969:III – 1973:IV	5.8	13.9	-2.1	-8.0
1973:IV – 1980:I	8.3	13.6	8.6	7.9
1980:I – 1981:III	6.9	7.7	3.5	3.7
1981:III – 1988:III[d]	5.2	4.9	27.1	25.5

Sources: Computed from U.S. Department of Commerce, Bureau of Economic Analysis, National Income and Product Accounts, 1929-82, and Survey of Current Business, July 1986, 1987, and 1988, and September 1988.

[a] Peak and trough in terms of the size of the real general account surplus.

[b] Deflated using the implicit GNP deflator for state and local government purchases.

[c] From the beginning of one contraction to the end of the following expansion.

[d] The latest data available at the time of this writing.

The general surplus as a percent of expenditures averaged 0. 7 percent during the 1975-80 expansion compared to 1.6 percent in the present expansion. Similarly, the deficits during the 1981-82 contraction were much smaller than those in past contractions-an average of 0.1 percent during 1981-82-versus 2.4 percent in 1973-74. This means that state and local governments have had a greater opportunity to accumulate fiscal resources during the 1980s. It is this long expansion that may have helped state and local governments withstand the federal aid reductions without substantial tax increases. The condition of every state and local government is not strong but the sector as a whole appears to be doing better in the 1980s than it did in the 1970s.

Another dimension of fiscal health is stability. The surplus is known to be cyclical-it falls during contractions and rises during expansions. Has it reacted more or less to the business cycles of the 1980s? We have calculated a cyclical swing in the general surplus, i.e., the difference in the average quarterly general surplus in a contraction and that in the following expansion. The greater the swing, the more sensitive the surplus is to a particular business cycle. For example, the average quarterly surplus swung from a negative $4.58 billion during the 1969- 70 contraction to a positive $1.19 billion during the 1970-73 expansion for a swing of $5.77 billion during the 1969-73 cycle (Table 4.10). The results of computing these swings in real terms for all business cycles in the 1970s and 1980s leads to the conclusion that the surplus has been markedly less cyclical in the 1980s.

This is consistent with the hypothesis that the 1980s brought a more conservative fiscal behavior on the part of state and local governments. The painful lessons learned in the 1970s almost certainly made state and local governments more risk averse, and many of the frills were trimmed away from budgets. The increased use of general contingency funds in the 1980s and significant discretionary increases in taxes in response to the 1981-82 recession indicated an attempt by state and local governments to stabilize their fiscal condition.[17] As emphasized by John Shannon, state and local governments could not count on a federal bailout during the recession as in the 1970s, so they had to respond quickly on their own.[18] Risk aversion also forced state and local governments to build their expectations about the macroeconomy into their fiscal planning: a better job of prediction may have been done, and improved accounting and performance budgeting systems have made better expenditure control possible. The result is that even some central cities, the hardest pressed segment of the local government structure, were recording positive general fund balances in the mid-1980s. Dearborn concluded that large cities were "in perhaps the best financial condition they have been in since 1971, as judged by their success in balancing budgets and maintaining balance sheet surpluses and liquidity.''[19]

The Response to Bush Federalism

The Bush administration's version of fiscal federalism is not yet known. Yet, one can speculate about three policy areas where state and local government finances will be significantly affected during the time of this administration. The most important-a legacy of the Reagan program- is the longer-run reaction of state and local governments to the 1986 tax reform, which we argue here will slow the growth in the state and local government sector. The other two are areas where policies of the new administration will have an impact on the fiscal balance among the federal, state, and local government sectors. The deficit will likely encourage a continuation of the policy of no real growth in federal grants, which will reinforce the tax reform in encouraging a smaller state and local government sector. Finally, the deficit may force the administration to propose further tax policy changes such as removing deductibility for state and local government income and property taxes, increasing the effective marginal personal income tax rate, or enacting a national sales tax. Any of these policies could have important effects on the role of the state and local government sector in the public financing system.

The 1986 Tax Reform

The new tax code was never intended to influence the federal structure, but it well may cause state and local governments to adjust their thinking about how they should tax as well as how much they can afford to spend and borrow. The fact is that the federal tax reform could activate or accelerate a chain of other events: possible reductions in state aid; heightened fiscal competition between the city and its suburbs; impacts on the poor; stimulation of investment in the service sector; and changes in personal tax burdens. The features of the tax reform that will be responsible for these impacts include (a) elimination of deductibility for passive real estate losses and sales taxes, (b) reduction in the marginal tax rate, and (c) elimination of certain tax preferences for capital intensive, goods producing industries.

City-Suburban Competition

One consequence of federal tax reform will be increased city-suburban competition for a smaller pool of state grant money. This will come about because of slower natural growth in state revenues, which will depress state aid, and an increase in the relative price of suburban property taxes. Consider first the prospects for a slower growth in state government revenues. Elimination of sales tax. deductibility and

reduction in the federal marginal tax. rate will raise the price of state and local government tax.es for those who itemize deductions.[20] Itemizer-voters may react to this by demanding lower state taxes. Research does not provide a clear answer about how great this reaction might be. Gramlich's[21] analysis suggests that it may be small; Kenyon[22] and Inman[23] find an effect on income but not sales taxes; and Feldstein and Metcalf[24] estimate a positive response from combined personal taxes on income, consumption and property values. Assume, as seems reasonable, that the longer- run growth in state sales and income taxes will be less than would have been the case if the marginal federal tax rate had not been lowered. With a slower growth in taxes, and with further cutbacks in federal aid, it is likely that the revenue pool available from which to draw state aid to local governments will be smaller in the future than it would otherwise have been. History has shown the state aid share of total state government expenditures to remain approximately constant, hence we might expect under this scenario to have lower state aid than otherwise would have been the case.

The other side of this story is that the competition for this reduced pool of state aid will be more keen. As state aid is reduced, pressure will build on the local property tax to pick up some of the slack. This will be resisted by industrial taxpayers, particularly because some capital-intensive firms will have experienced a significant tax increase due to the 1986 reform. Suburban residents, who have higher incomes and are more likely to itemize, will lose some of the federal subsidy to their property tax bill. Their property tax will have risen. It is almost certain that these voters will resist tax increases designed to compensate for federal aid reductions, and they will look to the state capitol for relief in the form of increased school aid. Such proposals are not likely to fall on deaf ears in the suburban-dominated state legislature. Cities, whose residents do not suffer as much directly from the loss of deductibility and the lower marginal tax rates, may not fare well in such a competition. Moreover, if the increased state aids are funded from cuts in social programs, city residents will be doubly damned.

How might this situation be avoided, that is, how might the potential revenue reductions be covered? Consider the possibilities: (a) increased federal aid; (b) increased growth rates in state and city economies; (c) increased sales, income, or property tax rates; and (d) retrenchment. The first seems highly unlikely. The second will occur in some places but not others. The third seems improbable, especially for states that are already in a noncompetitive taxing position, because the ''price'' of tax increases is now higher, and because some states have just taken a major step in the direction of lowering income taxes. Expenditure reductions and heightened city-suburban competition for a smaller pool of state aid are almost certain to result.

Impacts on Cities' Taxable Capacity

Federal tax reform also will affect the strength of central city economies and the ability of city tax systems to draw on it. Not only do reductions in the real growth of federal and state aid seem certain, but federal tax reform may lead to a dampening of the growth in taxes raised by city governments. Why? First, because the higher effective price of sales, income, and property taxes will heighten taxpayer resistance. Second, the lower marginal tax rate and the disallowance of passive real estate losses are provisions of the tax reform that will reduce implicit subsidies to both housing consumption and investment[25] On the consumption side, this may reduce the demand for home ownership among itemizers which, in turn, will depress the growth in real estate values and the property tax base. On the investment side, the removal of tax preferences for new plants and equipment may discourage new

construction. These impacts are especially important because the growth in the property tax base and yield are more heavily dependent on new construction than on reassessment.

There is, potentially, a brighter side of the tax reform story for the economy of large core cities. The new tax code removes an investment subsidy that has benefited manufacturers who make disproportionately heavy investments in plant and equipment. As a result, the relative profitability of investments in the service sector, including finance, will increase. This should help urban governments whose economies are concentrated in the service sector: for example, services now constitute about 45 percent of New York City employment compared to only 11 percent in manufacturing.

From the point of view of manufacturers, especially the most capital intensive, federal tax reform will discourage investment in plant and equipment. That is bad news for cities that still rely heavily on a manufacturing base. One could argue that the new code will further shake the already weak competitive position of many capital intensive, goods- producing firms. The long term effects are difficult to analyze.

Interstate Competition and Expenditure Reductions

In high taxing states, it seems clear that the tax burden disparity with the rest of the nation is potentially widened by federal tax reform. One study estimated the overall impact as follows: while high-income New York City residents would see a 5 percent tax increase, comparable families in New Jersey and Connecticut will see a 4 percent reduction.[26] More-over, lower taxing states, those with fewer itemizers, and those without income taxes will improve their competitive position.

Federal aid reductions and the reduction in the federal tax subsidy will force all states to rely more heavily on their own financing. This suggests that states will be more hesitant to let their tax rates drift ''out of line,'' particularly those that already are relatively high. In fact, one view is that more than ever before, states and cities will compete for jobs using fiscal incentives.[27]

To the extent that economic development objectives will drive state fiscal policies more than they presently do, distribution of income through the public sector may suffer.[28] This is because such policies are likely to be neither pro-urban nor pro-poor. Tax incentives to attract industry will be focused on company tax ''holidays'' or reduced tax rates, industrial and commercial property tax forgiveness, and a reduction in the top marginal personal income tax rates. There also will be pressure to reduce taxes on certain types of businesses to compensate for federal tax increases. On the expenditure side, the story is much the same. Industrial subsidies to attract plant location and general improvements in infrastructure will be leading candidates for inclusion in state or local government industrial policy. Education services may also play a role, likely in the direction of improving technical training or the general education system in the state.

Suppose a state were to follow such a strategy of competitive industrial subsidies? What are the implications for its public finances? Lower state taxes mean less direct state spending and less state aid for urban pro- grams. Industrial policy type reforms may also reduce the built-in elasticity of the income tax. Consider the case of New York which enacted reforms in 1987 that cut the level of taxes and reduced the built-in elasticity of the income tax, i.e., its potential revenue response to future income growth. This reinforces the tendency for a slower growing state and local government sector. Finally, the tax structure changes implied for such an economic development program (income tax and business property tax reductions) reduce the progressivity of the tax system.

The other side of the story is that the right industrial policy programs might stimulate job growth in cities. The problem here is that central city employment in much of the nation is growing relatively slowly, indicating that the city's business climate is not competitive and will not share fully in a successful state industrial policy. As for the effect of employment growth on alleviation of urban poverty, it is clear that even low-paying service sector jobs are not a good match for the lowest income unemployed in central cities.[29]

Effects on Poor People

Another way to view tax reform is in terms of its effect on people, and especially on the poor. The urban poor are not affected directly by federal tax reform since, in general, they do not pay income taxes. Thus they will receive no more take-home pay as a result of lower federal rates, and they would pay no more if the state government kept the windfall. Actually, the urban poor might fare better in the short run if the windfall were spent on human capital development in inner cities.

More important are the indirect effects on the urban poor. We can but speculate about these. One scenario is that the long-run income elasticity of the reformed federal income tax (and state income taxes) will be lower, suggesting a lower revenue yield relative to GNP in the future. If national income growth slows, even greater federal aid cuts will be forced. These cuts may be borne heavily by the social programs. State aid and direct expenditures for the poor also could suffer because of removal of the federal deductibility subsidy and because of interstate and interlocal fiscal competition. In addition there may be less rental housing construction and a drift toward higher rents, both factors that compromise the real income position of the urban poor.

The more optimistic view is that the federal reforms will stimulate growth in the U.S. economy and that the urban poor will share in this growth. The possibility that the job growth in the city will capture the urban poor, however, may be wishful thinking. The events of the past decade seem to make it clear that those living in poverty are not likely to share in the employment benefits of a stronger national economic growth. It is also argued that increased jobs in the service sector will not improve the lot of the lowest income residents in the central city. Indeed, some have argued that service jobs do not ''fit'' the urban poorest, and may even exacerbate the unemployment problem.[30]

Possible New Structural Reforms

The solution to the federal budget deficit problem will almost certainly lead to some form of tax increase in the future. If the decision is made to raise the additional funds through income taxation, then two likely avenues of reform are a temporary income tax surrate and a reduction in tax expenditures such as, perhaps, deductibility of state and local government income and property taxes. While both of these measures will work in the direction of increasing federal revenues, it is not clear how they will effect the revenue raising decisions of state and local governments.

On the one hand, an increase in the marginal tax rate will reduce the after-federal-tax purchasing power of citizens, and therefore will erode the base which state and local governments tax. On the other hand, the higher marginal tax rate will increase the value of deductibility of income and property taxes and therefore will reduce the price of state and local government taxes. This will have the effect, all other things being the same, of removing some of the disincentive to increased state and local government taxation.

If the federal government were to move in the direction of broadening the federal income tax base by reducing certain tax expenditures, property tax and income tax deductibility would be a likely target. If deductibility were eliminated, or even reduced for these two taxes, the result would be to drive up the tax price for those who itemize deductions. The result would be an increased resistance to higher state and local government taxes and quite likely some pressure to lower the effective tax rate.

Conclusions

It is too soon to make a definitive argument that a permanent shift in the nature of American federalism has occurred in the 1980s. But the trends have clearly been bent. The new movement is toward fiscal decentralization, the passing down to subnational governments of the responsibility for a greater share of taxing and spending decisions. The state and local government share of total government direct expenditures and revenue responsibility has been increasing in the 1980s, reversing a longstanding trend of growing federal fiscal dominance, and the sector share of GNP increased during the 1980-87 time period. At the same time, the dependence on federal grants has declined dramatically and grant conditionality has been eased, giving local governments more discretion over what they do receive. Finally, the deductibility subsidy has been reduced, thereby bringing a closer correspondence between the amount a state or local government chooses to spend and the amount of revenue it must raise.

Some would argue that the changes in the 1980s do not represent a structural shift but rather only some temporary reactions to the times, and that such temporary breaks have long characterized the state and local government sector.[31] While it is true that the sector share of GNP and the ratio of taxes to personal income have increased during this decade, both are just now back to their pre-Proposition 13 levels. It also could be said that fiscal behavior in the 1980s has been a product of conservative politics and economics, and in time even this will change. Yet, the "turning point" in state and local government finances seems to have been reached about 10-12 years ago and this is a long period for a temporary change. Moreover, history suggests that once a new pattern of behavior is established by governments, it takes some form of shock to displace this behavior.[32]

Why has the U.S. fiscal system become. more decentralized? The conventional reason for a push to stronger local government is the desire to get government decision making closer to the people. Centrally imposed expenditure mandates or direct central expenditures, unless they correct for some externality that local governments could not or would not take into account, impose a welfare loss on society because local budgets do not correspond with local preferences. Decentralization, it is argued, will lead to more citizen participation in government and to a greater degree of accountability of local government officials to their constituencies.

It was not these traditional arguments that led to fiscal decentralization in the U.S. in the 1980s. The impetus came more from the notion that a smaller federal sector and a less interventionist government sector would allow American business to perform better. The tax reforms of 1981 and 1986 reduced personal tax rates and the elasticity of the federal income tax and made it all but impossible to go back on the federal aid retrenchment program. Grant consolidation and deregulation were peas from the same policy pod, and the reduction of the tax expenditure for deductibility was a way to both reduce the deficit and place state and local governments on the same playing field as other competitors for the use of GNP.

In many ways the setting was just right for the shift to decentralization. The president was enormously popular and a reduced federal involvement in the economy was at the core of his program. The balance of payments deficit had popularized the ideas of flagging productivity, the declining competitiveness of American business, and the need for less government spending and more private investment. The federal income tax was seen by most as the chief culprit--complicated, unfair, and a disincentive to investors and entrepreneurs-and the move to a lower rate and a flatter rate structure with elimination of some tax expenditures was accepted as a fair trade.

State and local governments seemed to be in a relatively good position to take the hits of grant retrenchment and removal of part of the deductibility subsidy. They had accumulated a substantial surplus during the long expansion and would be able to draw this down to buffer the reduced federal subsidies, and state and local government taxes were not high by historical standards. Anyway, state and local governments had been getting by with less. A new fiscal conservatism had grown up in the aftermath of the 1975 recession and the tax limitation movement. Finally, regional shifts in economic activity had reduced the interstate disparity in income so that the equalization mandate of the federal grant system no longer seemed as important as it once had.

The result of this confluence of factors is that we live in a much more decentralized fiscal system now than we did ten years ago. A greater fraction of every dollar's worth of public services consumed is directly provided by subnational governments, and the gap between what a state or local government spends and the amount of revenue it must raise has narrowed. An increasing share of state and local government budgets is being financed by user and benefit charges, and other nontax revenues. As the longer term reaction to the provisions of the 1986 tax reform unfolds, and if federal grant reductions continue, it is possible that state and local government budgets will grow more slowly and that fiscal competition among the states will become more intense.

The 1980s has been a time of rethinking the objectives of government in the U.S. and sorting out the roles of the three levels of government. The general tenor has been a shift in emphasis from the redistribution of income to efficiency. The results of this have shown up in both an improved fiscal responsibility at all levels of government and a growing population of the poor. In this new setting, state and local governments have been given more responsibility to allocate resources-that function which they do best. The next step in the sorting out process is to assign a responsibility for redressing disparities among state and local governments and for determining a proper division of responsibility for looking after the poor.

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[1] Anyone studying the United States federal system is in the debt of the Advisory Commission on Intergovernmental Relations (ACIR). In particular, their excellent biennial compilation Significant Features of Fiscal Federalism is invaluable in tracking the development of state and local government finances.
[2] See Roy Bahl, Financing State and Local Governments in the 1980s (New York: Oxford University Press, 1984), chapter 2.
[3] ACIR, Significant Features of Fiscal Federalism, 1980--81 edition, p. 29.
[4] Reported by Robert Gleason "Federalism's Fiscal Shifts," Intergovernmental Perspective 14, 4 (Fall 1988), 26.
[5] The term "social welfare expenditures" is used here to include all health, education, and welfare expenditures, and Social Security.
[6] Richard P. Nathan and John R. Lago, "Intergovernmental Relations in the Reagan Era," Public Budgeting and Finance 8 (Autumn 1988), 15--29.
[7] Survey of Current Business, April 1988, p. 13

[8] In Table 4.4, we define "average" as the unweighted mean value of the variable across the fifty states. For our purposes, this seems more appropriate than a weighted mean for defining a benchmark against which to compare interstate variations.

[9] The measure of relative variation used in Table 4.4 is the coefficient of variation, i.e., the standard deviation as a percent of the mean. The smaller the coefficient, the less dispersed the distribution. For example, the reduction in the coefficient for the ratio of federal aid to personal income between 1967 and 1987 means that the states are grouped more closely about the mean in the later year.

[10] ACIR, 1986 State Fiscal Capacity and Effort, Information Report M-165 (Washington, DC: U.S. Government Printing Office, 1988).

[11] Steven Gold and Judy Zelio, "Interstate Tax Comparisons and How They Have Changed Over Time," Tax Notes (March 20, 1989), pp. 1501-1512.

[12] The New York case is reported in detail in Roy Bahl, "Federal Policy," in Setting Municipal Priorities, Raymond Horton and Charles Brecher, eds. (New York: New York University Press, 1988), chapter 2.

[13] 13. See, for example, Thomas E. Borcherding, and Robert T. Deacon, "The Demand for Services of Non Federal Governments," American Economic Review 62 (December 1972), pp. 891-901; and Roy Bahl, Marvin Johnson, and Michael Wasylenko, "State and Local Government Expenditure Determinants: The Traditional View and a New Approach," in Public Employment and State and Local Government Finance, Roy Bahl, Jesse Burkhead, and Bernard Jump, eds. (Cam- bridge, MA: Ballinger Publishing, 1980), chapter 4.

[14] Only approximately $2 billion of this amount was paid by the states to the federal government, primarily to support the supplemental security income program which started in 1974.

[15] This section updates parts of Roy Bahl and William Duncombe, "State and Local Government Finances: Was There a Structural Break in the Reagan Years," Growth and Change 19, 4 (Fall 1988), pp. 30-48.

[16] The problems with interpreting the surplus measure are reviewed in Bahl, Financing State and Local Governments, chapter 2.

[17] See Steven Gold, "Preparing for the Next Recession: Rainy Day Funds and Other Tools for States," National Conference of State Legislatures, Legislative Finance Paper #41, December 1983.

[18] John Shannon, "Federal and State-Local Spenders Go Their Separate Ways," American Intergovernmental Relations Today, Robert J. Dilger, ed. (Englewood Cliffs, NJ: Prentice Hall, 1986), pp. 28-46.

[19] Phillip Dearborn, "Fiscal Conditions in Large American Cities, 1971-84," paper prepared for the National Academy of Sciences, Committee on National Urban Policy, 1986, p. 36.

[20] One estimate is that the relative tax price of the sales tax will increase by eight percent because of the reform. This is discussed in Dennis Zimmerman, ''Federal Tax Reform and State Use of the Sales Tax,'' Proceedings of the Seventy- Ninth Annual Meeting of the National Tax Association-Tax Institute of America, pp. 325-33, November 1986.

[21] Edward Gramlich, "The Deductibility of State and Local Taxes," National Tax Journal (December 1985), 447-464.

[22] Daphne Kenyon, "Direct Estimates of the Effects of Tax Deductibility on State Tax Mix and the Level of State Taxing and Spending,'' mimeo, 1985.

[23] Robert Inman, "Does Deductibility Influence Local Taxation," National Bureau of Economic Research (NBER) Working Paper 1714 (October 1985).

[24] Martin Feldstein and Gilbert Metcalf, "The Effect of Federal Tax Deductibility on State and Local Taxes and Spending,'' Journal of Political Economy 95, 4 (August 1987), 710-736.

[25] These effects are discussed in James R Follain and Patrick H. Hendershott, Tax Reform and Real Estate: The Impact of the Senate Finance Committee Plan (Washington, DC: The Urban Institute, 1986).

[26] 26. Office of the State Comptroller, ''The Potential Impact of Federal Tax Law Changes on New York City and New York State,'' mimeo, New York City, 1987.

[27] There is a longstanding debate in the literature about whether fiscal incentives matter in the location choices of firms. The argument that they are not important is made in D.W. Carlton, "The Location and Employment Choices of New Firms: An Econometric Model with Discrete and Continuous Endogenous Variables," Review of Economics and Statistics 65, I (1983), 32-40. For the opposing view, and some empirical evidence, see Leslie Papke, ''Subnational Taxation and Capital Mobility: Estimates of Tax-Price Elasticities," National Tax Journal 40, 2 (June 1987), 191-204.

[28] Roy Bahl, "Industrial Policy and the States: How Will They Pay?" Journal of the American Planning Association (1986), reprinted in The State and Local Industrial Policy Question, Harvey A. Goldstein, ed. (Chicago, IL: Planners Press, American Planning Association, 1987).
[29] John Kasarda, "Jobs, Migration, and Emerging Urban Mismatches," in Urban Change and Poverty, Michael McGeary and Laurence Lynn, eds., 148-97 (Washington, DC: National Academy Sciences Press, 1988).
[30] William Julius Wilson, "The Urban Underclass in Advanced Industrial Society," in The New Urban Reality, Paul E. Peterson, ed., 129-160 (Washington, DC: Brookings Institution, 1985).
[31] See, for example, Deil S. Wright, Understanding Intergovernmental Relations, 3d edition (Pacific Grove, CA: Brooks/Cole Publishing, 1988), chapter 12.
[32] This ''displacement effect'' is analyzed in Alan Peacock and Jack Wiseman, The Growth of Public Expenditures in the United Kingdom (London: Allen & Unwin, 1967).