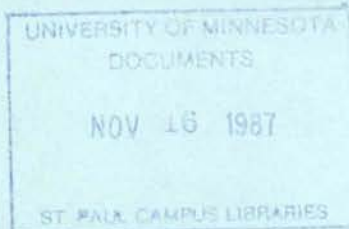


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**SPEAKING OF TAXES**

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**FEND-FOR-YOURSELF FEDERALISM**

by Arley D. Waldo  
University of Minnesota

Who should pay for local schools, job training programs, helping the poor, streets and highways, fire and police protection, medical care for the elderly, sewer and water systems, low-income housing, parks and playgrounds? Federal taxpayers? State taxpayers? Local taxpayers? Answers to these questions are not always clear. And the fiscal balance between federal, state, and local responsibilities keeps changing.

Early in his first administration, President Reagan called for a "New Federalism" that would sharply change federal-state fiscal relations and re-align responsibilities for providing public services. The original proposal got nowhere, but the label stuck. Now a new term has emerged -- Fend-for-Yourself Federalism -- recognizing the declining federal support for domestic (nondefense) public services and the mounting fiscal responsibilities of states and localities.

**FEDERAL SPENDING.** With federal government spending now exceeding a trillion dollars annually, it is all too easy to forget that responsibility for day-to-day administration -- and funding -- of domestic public services is borne chiefly by state and local governments.

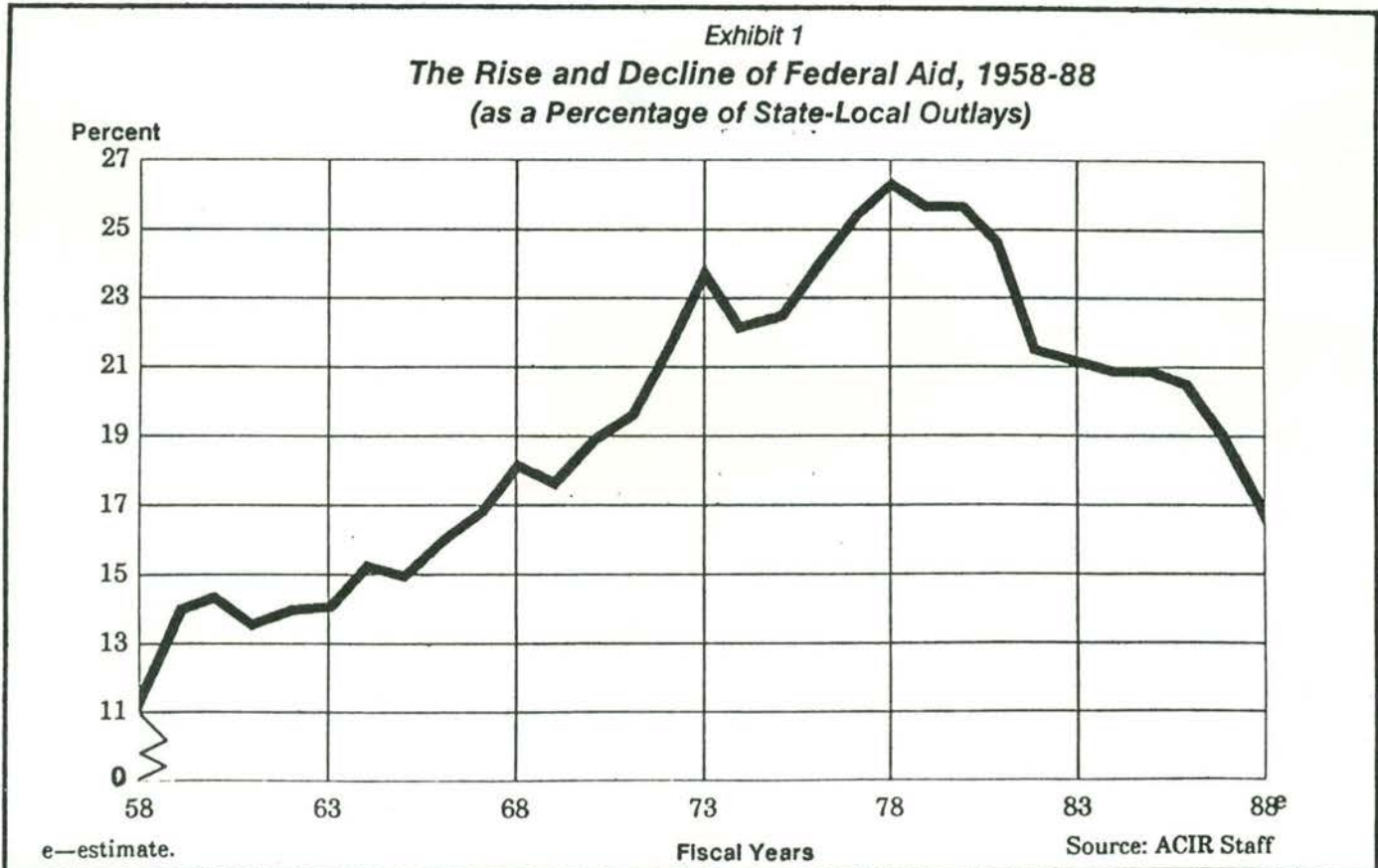
Federal outlays are dominated by three broad spending categories: (1) national defense, (2) social security and other income maintenance programs, and (3) interest on the federal debt. These expenditures represent a little over 80 percent of total federal spending. All other federal spending -- for everything else the federal government does, including federal aid to state and local governments -- is less than 20 percent of the total. Schools, roads and streets, police and fire protection, water and sewer systems, parks and playgrounds, etc. are largely state and local responsibilities.

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In 1985 (the most recent year for which detailed information is available), federal, state, and local government spending in the United States totaled a little over \$1,581 billion. Of that amount, federal outlays for national defense and international relations, the postal service, space research and technology, interest on the federal debt, social security, and federal employee retirement benefits were \$742 billion. All other government expenditures (federal, state, and local) totaled about \$839 billion. State and local government outlays accounted for more than 3/4 of that total (a little over \$658 billion). Approximately 84 percent of state and local spending was financed by state and local governments from their own revenue sources. Federal aid paid for the other 16 percent.

Of course, the federal government does help finance domestic services both directly and, most importantly, by providing financial assistance to state and local governments. The principal means of federal help are grants-in-aid, loans, and tax subsidies to state and local governments. But federal help for state and local governments has fallen dramatically.

THE RISE AND FALL OF FEDERAL AID. From the end of the Korean War to the late 1970s, federal aid to state and local governments and direct federal provision of domestic services grew rapidly. By 1978, federal aid accounted



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for over 25 percent of state-local government outlays. That period of fiscal history ended during the Carter administration, and the downturn in federal aid has accelerated under President Reagan. Federal cutbacks have forced state and local governments to assume a larger role in providing and financing domestic services.

The budgets of state and local governments were ravaged in the early 1980s by a combination of falling federal support, inflation, and recession. And economic distress in rural communities compounded the fiscal problems of Minnesota and other states in which farming is important. States coped with budget shortfalls. State-local taxes were increased, and budgets were cut.

We are still adjusting to changes in federal-state fiscal relations. But it is clear that a larger share of the services we want will have to be paid for by state and local taxpayers. States are increasingly on their own.

Most recently, state and local governments have felt the effects of federal tax reform and the end of the federal general revenue sharing program.

FEDERAL TAX REFORM. State and local policymakers were particularly concerned about three issues in the move toward federal tax reform.

First, as originally proposed, the administration's tax plan would have eliminated the deductibility of all state and local taxes on federal tax returns. Some officials feared this would cause greater taxpayer resistance to hikes in state and local taxes -- tax increases seen by some as necessary to help offset the drop in federal aid. As finally enacted, however, only the deductibility of sales taxes was eliminated.

Second, the tax reform law that emerged did cut significantly the federal subsidy given to state and local governments through tax preferences for state and local bonds. Bonds qualifying for exemption from federal taxation were restricted by the tax reform measure by tightening the definition of "public purpose" and increasing the percentage of bond proceeds that must be used for public purposes. Moreover, the amount of "tax free" bonds that can be issued in any state was capped.

Finally, the notion of federal tax reform was to combine a closing of "tax loopholes" (thus broadening the tax base) with a

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reduction in tax rates. Federal income tax rates were cut, and the federal tax base was enlarged. For states that conform closely to the federal definition of taxable income, as Minnesota does, expansion of the federal tax base meant an automatic increase in state income tax collections unless specific action was taken to return this "windfall" (or at least a portion of it) to state taxpayers. Some states took this as an opportunity to increase state tax revenues. Minnesota returned the so-called windfall to taxpayers by cutting tax rates to offset the expanded tax base.

THE END OF REVENUE SHARING. Local government budgets have also been hit by the end of the federal general revenue sharing program. Congress allowed the program to expire in 1986. In its final year, the revenue sharing program distributed about \$4 billion to 39,000 local governments across the country. Revenue sharing never represented more than a small fraction of federal aid to state and local governments; but, for many smaller jurisdictions, revenue sharing was their only direct source of federal financial assistance. That money is now gone.

REFORMING MINNESOTA'S TAX SYSTEM. Even before federal tax reform became law, the clamor for tax reform swept from the halls of Congress to state capitols across the nation. In Minnesota, a comprehensive plan for tax reform was the centerpiece of the Governor's 1987 legislative package. At the heart of the plan was a pledge to return the potential windfall from federal tax changes to state taxpayers by cutting state income tax rates. Other features of the plan were to reduce corporation income tax rates (but to provide a new minimum tax for corporations), broaden the sales tax base, and simplify the property tax. A host of other tax law changes were also proposed.

The stated objectives of the tax reform package were to make Minnesota more competitive with other states (meaning reduce individual and corporation income tax rates compared to other states), stabilize the state's revenue system, simplify the tax system, and improve accountability between state and local governments and taxpayers.

In the end, Governor Perpich got most of what he asked of the 1987 Legislature. But the road to a final tax bill was arduous -- perhaps partly because the Governor's own DFL party controlled both houses of the Legislature by sizable margins. Intra-party compromise can be tricky business.

Minnesota's individual income tax system was simplified by closely adhering to the new federal tax law. Minnesota taxpayers will now begin calculation of their state tax liability by using

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federal taxable income (not adjusted gross income). The potential windfall from expansion of the federal tax base was returned to the taxpayers by reducing state income tax rates and the number of tax brackets. A sizable number of low-income taxpayers will be dropped from state tax rolls. For taxpayers at higher income levels, tax rates have been cut.

We did not, however, hold the line on taxes. For the 1988-89 biennium, state tax increases are estimated at around \$700 million -- an increase of more than 7 percent. This increase is the result of the new minimum tax on corporations (although corporation income tax rates were reduced), a broadening of the sales tax base, and higher excise taxes.

The major unanswered question is what will happen to local property tax levels? For the time being, property taxes may rise only moderately because of a temporary tightening of local levy limitations. But local governments are struggling to balance their budgets for next year, and more than 150 local governments have requested authority to exceed their levy limits for property taxes payable in 1988. What may happen after that will depend on future legislative sessions. Further efforts to modify the property tax system will be high on the list of legislative priorities when the 1988 Legislature convenes next February.

ECONOMIC COMPETITION AND STATE TAX POLICY. Bashed by the 1981-82 recession, states stepped up their efforts promote economic growth. Despite economic recovery, the outlook for the national economy has been clouded by unprecedented federal budget and international trade deficits. And the farm economy has been propped up by soaring government payments that are a tempting target for federal budget cutters. Now, the recent stock market "meltdown" has created still more uncertainty about the future of the economy.

States are competing vigorously with one another for new jobs and businesses. Tax competition between the states has been part of the battle. No state wants tax levels so high that they might deter economic growth. At the same time, however, states are struggling to undertake programs that will promote long-term growth -- better schools, improved transportation systems, economic development incentives, etc. These programs cost money -- money that increasingly must come from state and local taxpayers.

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State policymakers, in this new fend-for-yourself fiscal environment, are thus faced with balancing a desire keep the lid on tax levels against increased spending on programs that may enhance state economic growth. The choice is not an easy one.

Arley D. Waldo is Professor, Public Finance and Tax Policy, Department of Agricultural and Applied Economics, and Extension Economist, Public Policy, Minnesota Extension Service, University of Minnesota.

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