State and Local Governments
An Assessment of their Financial Position and Fiscal Policies

State and local governments are at a crossroads in fiscal planning. The sector as a whole finished 1983 with a budget surplus of $15 billion, the highest ever. The surplus could be even larger in 1984 Nevertheless, most state and local policymakers are taking a cautious view toward their financial outlook. Their concern has raised two issues. The first is the degree of austerity state and local governments should maintain as they formulate their budgets for fiscal 1985 and lay the groundwork for 1986. The second, at a broader level, is the impact the mix of policies they select will have on the economy over the course of future business cycles.

The caution being exercised by state and local governments in ordering their priorities for reducing taxes, increasing spending, and retaining large surpluses is understandable. During the past three years, a record number of them faced annual budget crises, and in 1982 the sector had a deficit of $2 billion. Over the course of 1983, three factors accounted for the $17 billion improvement in their financial position. One was the strength of the recovery which began early in that year. The other two, starting in 1981 and escalating through 1983, were a series of tax increases and a determined effort to restrain the growth of spending. Neither of these were easy steps to take.

The budget decisions facing state and local governments are further complicated by the fact that several of the circumstances which set the stage for their earlier financial troubles are prevalent once again. One is the projected large Federal budget deficits. Another is the combination of state and local surpluses, their relatively high level of taxes, and their low levels of real spending

Under similar situations from 1978 to 1980, the Federal Government slowed the growth of intergovernmental transfers, and states and localities enacted the largest tax cuts in their history These two courses of action, especially the second one, significantly contributed to the severity of their subsequent financial problems. If they were pursued vigorously again today, it could leave state and local governments more financially vulnerable than they appear to be now.

The concern over the potential macroeconomic impact of state and local fiscal policies is also based on recent experience. During business cycles prior to 1980, state and local government policies had an effect similar to that of a shock absorber, working to cushion recessions and to dampen recoveries. In doing so, their policies tended to support the automatic stabilizing effects of Federal fiscal policies. This was not the case during the two recessions between 1980 and 1982. As the analysis in this article shows, the state and local sector had only a very slight moderating impact on the 1980 recession and tended to aggravate the recession from mid-1981 through the end of 1982

The effect state and local governments have had on past economic cycles follows in part from the manner in which they plan their budgets. Most of them forecast revenues over a one- or two-year horizon and then

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specify their spending levels accordingly But, during a recession, tax receipts are likely to fall short of their projected levels If the downturn does not last too long, though, the intended level of expenditures can still be financed by drawing down previously accumulated balances In a recovery, the growth of tax receipts will accelerate, spending can increase at the planned rate, and surpluses are built up once again In both instances, the net effect of state and local fiscal policies is countercyclical

Between 1980 and 1982, however, the budgetary process which enabled state and local governments to moderate earlier downturns was not effective In particular, their accumulated balances prior to the 1980 and the 1981-82 recessions were already at low levels following their own tax cuts and the reduction of Federal grants Throughout the last two recessions, then, in contrast to previous ones, states and localities were forced to maintain or to fortify their surpluses by reducing the growth of spending, raising taxes, or both

The consequences on the overall economy of states and localities having to rebuild their surpluses in a recession became especially apparent in the most recent downturn During the 1981-82 recession, the Economic Recovery Tax Act of 1981 (ERTA) is estimated to have cut total Federal taxes by $39 billion At the same time, however, this article shows that approximately 37 percent of that reduction was offset by discretionary tax increases at the state and local level

The state and local surplus in the current recovery is indicative of a policy mix which is, once again, a moderating influence If pressures should build to reduce this surplus through lower taxes, increased spending, or reduced Federal aid, then the reinforcing impact the state and local sector had on the last recession may not prove to be a fluke. The outcome could be critical from the standpoint of coordinating fiscal policies across all levels of government

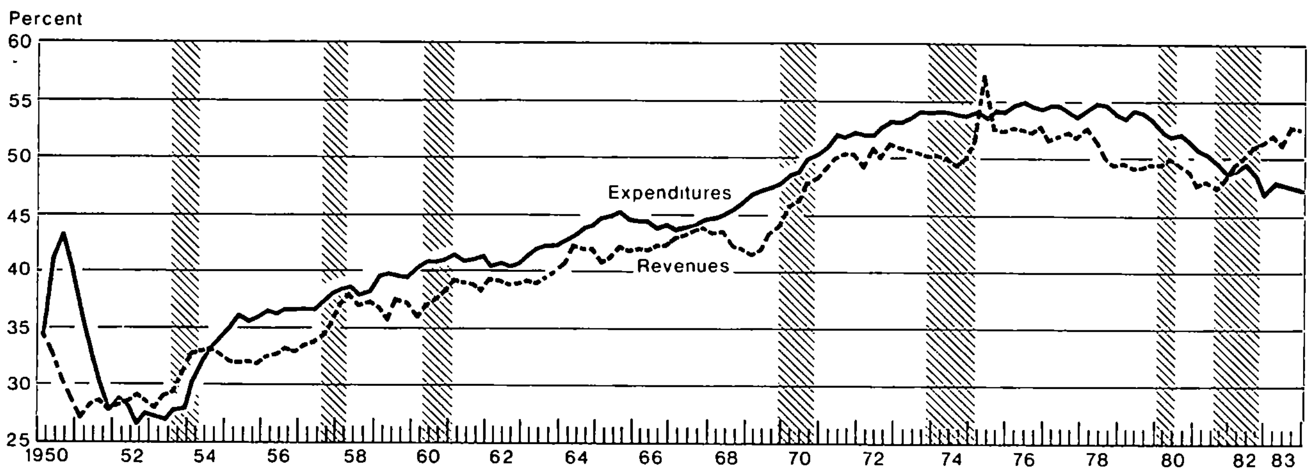
The fiscal planning situation in which state and local governments now find themselves did not come about overnight It is the outcome of a series of events which continually reshaped the economic activities of state and local governments and their interrelationships with the U S economy and the Federal Government The purpose of this article is to analyze these events and to shed light on the decisions facing state and local policymakers

Fiscal profile of state and local governments

At the outset of this analysis, it is useful to review the concept of financial status for state and local governments Ideally, one measure of that status would be

Chart 1

State and Local Revenues and Expenditures as a Percentage of Total Government Revenues and Expenditures*



All figures are on a national income and product account basis Shaded areas represent periods of recession, as defined by the National Bureau of Economic Research

*Social insurance revenues and expenditures are excluded

Source U S Department of Commerce, Bureau of Economic Analysis

suitable for quantifying changes in financial conditions for individual state and local governments, for the sector as a whole, and for the sector with respect to the rest of the economy Unfortunately, no such single measure exists.

The national income and product accounts (NIPA) provide a basis by which the state and local sector can be analyzed as a component of the overall economy. However, this concept of the sector's budget surplus or deficit can give a very different impression of financial conditions than one obtained by looking at the budgets of state and local governments. There are several reasons for this.

First, the NIPA definition of surplus and deficit includes capital expenditures such as those for schools or roads on the spending side of the state and local sector's budget. But it does not include the funds borrowed to finance those projects on the revenue side. Most states and localities, though, in contrast to the Federal Government, have a capital budget which is separate from their current operations budget. This means that, if a sufficiently large amount of capital expenditures were financed by issuing debt, the NIPA measure could show a deficit, even though state and local governments had surpluses in their current operations budgets

Second, the NIPA budget measure does not include accumulated balances which state and local governments can carry over from the previous fiscal year into the current year. Yet, states and localities consider these balances when assessing their financial outlook and when planning their budgets. For example, a state which had ended the previous year with a large accumulated balance, could run a small operating deficit in the current year and, by its method of accounting, still end the year with a surplus.

Finally, it is important to separate, as the NIPA do, the state and local sector's social insurance funds (primarily pensions) from its current operations budget. The surplus in the social insurance fund, which amounted to more than $36 billion in 1983, is an important component of credit markets in the United States. However, the surplus is reserved for future pension obligations and cannot be used to finance the current operations of state and local governments.

When social insurance programs are excluded, states and localities in the United States account for about half of the economic activity for what is commonly referred to in other countries as the general government—Federal, state, and local governments combined (Chart 1). Of course, in terms of their fiscal operations, state and local governments differ from the Federal Government in a number of areas.

Budget requirements

Unlike the Federal Government, all state and local governments (except Vermont) are required by law to enact balanced operating budgets.[1]

There are three implications of the balanced budget requirement. First, a deficit is not the only budget outcome that can constitute a potential problem. Projections for a small surplus or a balance at the beginning of the fiscal year could also be cause for concern. If unanticipated revenue shortfalls or additional spending needs were to arise, it could necessitate further legislative measures during the year in order to avoid an end-of-year deficit. For this reason, most governments prefer to design their budgets so that their projected balance at the end of the year equals 5 percent or more of expected outlays.

Second, without deficit spending, state and local governments cannot be so responsive to deteriorating economic conditions as can the Federal Government.

Third, the level and composition of Federal grants can have a decisive effect on state and local taxing and spending decisions When assessing the impact of the state and local sector on economic cycles, then, it is important to distinguish the effects due to its own discretionary actions from those due to changes in Federal aid.

Policy objectives

For the most part, state and local governments are concerned with providing the desired level and distribution of services for their constituents without creating an unfavorable tax climate. The desire of a state or locality to increase its spending must be weighed against the risk of losing business and household income to other jurisdictions, given that it may also have to raise taxes.

Revenues

State and local revenues can be divided into two categories. The first—own-source receipts—is comprised of taxes, charges, and fees and currently generates just over 80 percent of the sector's revenue. In 1983 this amounted to nearly $360 billion, or 13.1 percent of aggregate personal income in the United States. In contrast, Federal taxes excluding social insurance contributions amounted to about 15 percent of personal income. The remainder of the state and local sector's total revenue is provided by the Federal Government in

[1]If a deficit should arise during the fiscal year, it can be financed by drawing down accumulated balances, raising taxes or accelerating their collection, and reducing or postponing expenditures To avert cash-flow problems during the year, states and localities can issue short-term debt in the form of either tax or revenue anticipation notes (TANs or RANs)

the form of grants. Federal aid was just over $86 billion during 1983

The primary contributors to state and local own-source receipts are sales taxes and the property tax. Together they presently account for about 56 percent of the total. Next in order of magnitude are taxes on individual income (17 percent) and corporate income (5 percent)[2] Other components of own-source receipts include estate and gift taxes, severance taxes, hospital and health charges, rents and royalties, user fees, and licenses

State and local governments administer two types of sales taxes. One is the broad-based general sales tax which is specified as a percentage of the price of a product or service. The other is made up of selective sales taxes—sometimes referred to as excise taxes—which are levied on a unit of output The principal sources of revenue in the latter category are taxes on motor fuels, tobacco products, and alcoholic beverages.

An important trait of the state and local tax system is that it does not obtain nearly so much revenue from income-based taxes as the Federal Government does. Currently, taxes on individual income and corporate income generate about 21 percent of state and local own-source receipts but over 85 percent of Federal revenue (excluding social insurance tax receipts). The significance of this disparity is that income-based taxes tend to be more elastic than other taxes. Of the major taxes at the state and local level, only the individual income and corporate income taxes have elasticities with respect to inflation which are greater than one[3] Because of this structural difference in tax systems, state and local own-source receipts are less responsive to changing economic conditions than Federal revenues are

Two points are often overlooked in regard to the second source of state and local revenue, Federal grants. The first is that almost half goes for direct transfer payments to individuals, such as Aid to Families with Dependent Children (AFDC) and medicaid benefits. Although they are measured as state and local expenditures, the primary role of these governments is to administer the programs For the most part, they have little or no discretion as to how or where the funds should be spent. Second, while roughly 75 percent of total Federal grants goes to state governments, much of this is eventually passed down to local governments Therefore, localities depend more heavily on intergovernmental aid than states do.

Expenditures

In 1983, state and local governments spent over $430 billion. The single largest category of expenditure is education. After that comes income support and welfare, health and hospitals, and transportation. Over 95 percent of their total spending goes to purchases of goods and services, including wages and salaries[4] In contrast, only about one third of all Federal expenditures go to purchases of goods and services as over half of all Federal outlays now go to benefit payments to individuals, *e.g.*, social security and medicare, and to interest payments on the debt.

Since virtually all state and local expenditures are for purchases, the spending side of their budgets is not automatically affected by cyclical changes in economic activity to the same extent as the Federal Government When considering all categories of Federal expenditures, many types of transfer payments, such as social security benefits, are likely to have automatic cost-of-living adjustments (COLAs). The level of interest outlays is also directly affected by economic fluctuations, because nominal interest rates adjust to higher or lower rates of inflation Purchases, however, are usually not automatically indexed or as responsive to changes in inflation

Trends

The fiscal profile of state and local governments has changed considerably over the postwar period This has been evident in their financial position as well as in the types of public services they provide and how they fund them Three general phases in the sector's economic activity have occurred since 1950. Each one is identified by the rate of expansion for the sector in relation to the Federal Government and to GNP and by the changing role of states and localities in the U.S. federalist system of government.

In the first phase, from 1950 through 1971, the state and local sector grew considerably faster than either the Federal Government (Chart 1) or GNP (Chart 2). During this period, it also absorbed a continually larger share of the economy's income and real resources. For instance, in 1950 state and local own-source receipts were about 8 percent of aggregate personal income. By the end of 1971, they had risen to 13.4 percent. Since most of this went for purchasing goods and services, the sector provided a strong stimulus for economic growth In real terms, its purchases increased from about 10 percent of GNP in 1950 to 13 percent in 1971

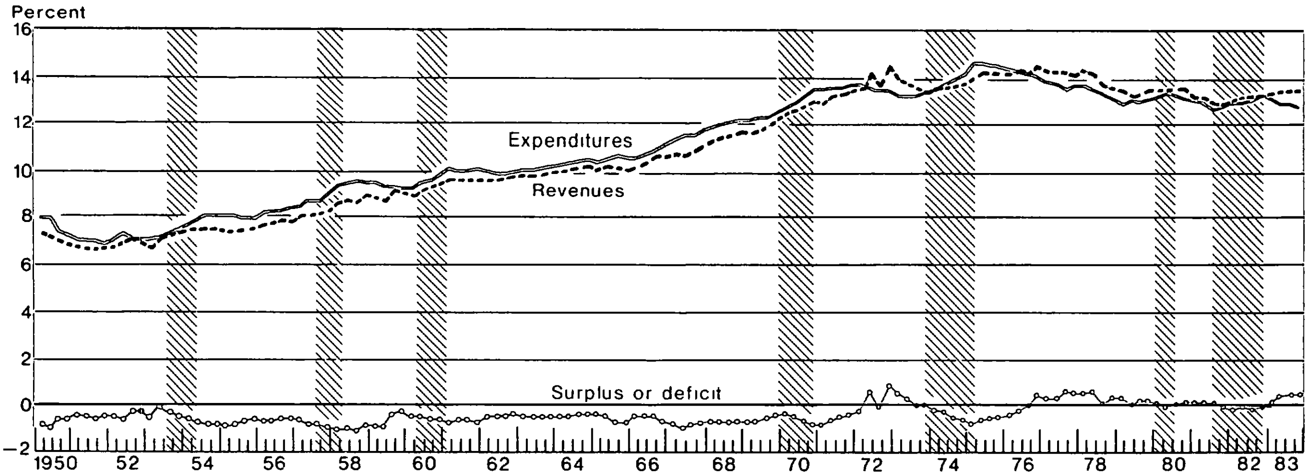
[2]Within the state and local sector, roughly 85 percent of the sales tax receipts, 90 percent of the individual income tax receipts, and virtually all of the corporate income tax receipts are collected by state governments Over 95 percent of total property taxes are paid to local governments

[3]This means that, if inflation increased by 1 percent, tax receipts will grow by more than 1 percent

[4]As defined in the NIPA, purchases of services include employee compensation This convention is used throughout this article

Chart 2

State and Local Expenditures, Revenues, and Surplus or Deficit as a Percentage of GNP*



All figures are on a national income and product account basis Shaded areas represent periods of recessions, as defined by the National Bureau of Economic Research

*Social insurance revenues and expenditures are excluded

Source U S Department of Commerce, Bureau of Economic Analysis

By contrast, over the same period, Federal tax and nontax receipts fell from 19 4 percent of personal income to 16.7 percent, and real Federal purchases grew from 8.8 percent of real GNP to only 9.2 percent

The rapid growth of the state and local sector was, in part, the natural consequence of shifting economic, demographic, and political conditions. Some of the contributing factors were the effect of the baby-boom on school enrollment, the construction of the interstate highway system, the growing need for other forms of infrastructure due to population migration, and the increased demand for income support and public welfare programs

The capacity of state and local governments to respond to each of these conditions was enhanced by the proliferation of Federal grants As shown in Table 1, grants rose sharply in current and constant dollars throughout the period. More importantly, perhaps, Federal aid as a percentage of state and local revenue nearly doubled, reaching over 20 percent in 1971 This meant that, although state and local governments were providing a broader range of goods and services, their ability to do so was becoming increasingly dependent on Federal budgetary policy.

Throughout the 1950s and 1960s, the state and local sector ran a continual deficit (Chart 2). However, this was not an indication of fiscal distress Rather, it was due both to the fact that states and localities were borrowing to finance capital projects and to the method by which this is accounted for in the NIPA.

There were several changes worth noting in the composition of state and local expenditures and revenues during this phase Most of them took place toward the end of the period and had a bearing on the direction of state and local fiscal policies during the decade that followed

On the spending side, the major development was the growing emphasis on outlays for income support and welfare between 1965 and 1971 (Table 2). Prior to that, the share of state and local expenditures for education had grown the fastest Throughout the period, the portion of outlays for transportation declined as the interstate highway system neared completion These developments were augmented by similar modifications in the composition of Federal grants (Table 3).

On the revenue side, starting in 1965 and continuing through 1971, there was a concerted effort by states to broaden their tax bases In that time alone, seven states adopted the individual income tax and eight added the general sales tax. Furthermore, in 1971 especially, a number of states that already had one or both of these two taxes raised their rates.

The move by states toward broad-based taxes was due in part to the fact that they are more elastic and, particularly in the case of the individual income tax, more progressive Their adoption, as well as the subsequent tax rate increases in 1971, was also motivated by the desire to supply local governments with additional revenues while providing their constituents with relief from the property tax. As the role of state and local governments in providing goods and services expanded, they could rely more on economic growth for the necessary additional revenues rather than on discretionary tax increases

The state and local tax reforms had a significant impact on the level and composition of their own-source receipts The period from 1968 to 1971 saw the sharpest sustained rise in own-source receipts in relation to Federal revenues (Chart 1) and personal income (Chart 3) in the postwar era Almost all the increase was accounted for by sales taxes (primarily the general sales tax) and the individual income tax

The second phase, starting in 1972, brought about a slowdown in the average rate of expansion of the state and local sector A principal reason for the deceleration was that the pressure from demographic factors that led to the rapid growth in the 1950s and 1960s, subsided in the 1970s For example, the enrollment of school-aged children from kindergarten through high school peaked in 1971

By the end of 1977, state and local expenditures and revenues were about the same as they had been six years earlier in terms of either the general government (Chart 1) or GNP (Chart 2) The composition of expenditures also did not change by much (Table 2) Although the level of state and local own-source receipts remained fairly stable with respect to personal income, the wave of tax reforms at the end of the first period had altered the composition The contribution of the individual income tax to total own-source receipts doubled (lower half of Chart 3) At the same time, the share accounted for by the property tax fell

The slowdown in state and local economic activities occurred despite the continued growth of Federal aid (Table 1) By 1977, grants had reached record levels in both nominal and real terms, and they accounted for nearly one quarter of state and local total revenues

There were two important changes in Federal grant policy during this period. One was the advent of Federal revenue sharing in late 1972. It gave state and local governments more of a voice in deciding which social service and welfare programs should be provided for and the extent to which they should be funded This is evident in Table 3 where a sharp drop in Federal aid for income support and welfare in 1973 was more than offset by the increase in grants going to the "other" category The second was a 24 percent surge in Federal grants in 1975 This time, much of it went to specific programs in the areas of social services and medical care

Perhaps the most important budget developments at the state and local level in this period were the fluctuations in the sector's financial position (Chart 2) The fluctuations were mainly the products of discretionary policies at all three levels of government However, state and local budgets had also become more responsive to changing economic conditions after the tax reforms of 1965 to 1971

There were three swings in the status of state and local budgets between 1972 and 1977 The first was a peak in aggregate surpluses during the recovery between the 1970 and the 1973-75 recessions Besides the healthier economy, the Federal revenue-sharing funds and a number of state tax increases accounted for the buildup The surplus soon turned to a deficit, however, as a result of the 1973-75 recession, a series of state and local tax cuts, and an acceleration in their expenditures. The third swing started after the second quarter of 1975 Own-source receipts were bolstered by the recovery, the second large increase in Federal

Table 1

Federal Grants to State and Local Governments*

Calendar year	Current dollars (billions)	Constant dollars (billions)	Grants as a percentage of total state and local revenue†
1950	2 4	4 4	11 6
1955	3 2	5 2	10 6
1960	6 5	9.5	14 0
1965	11 1	14 9	15 8
1970	24 5	26 8	19 4
1971	29 0	30 2	20 3
1972	37 5	37 5	22 4
1973	40 6	38 4	22 3
1974	43 9	38 2	22 3
1975	54 6	43 4	24 7
1976	61 1	46 2	24 6
1977	67 6	48 2	24 5
1978	77 3	51 4	25 5
1979	80 5	49 3	24 8
1980	88 7	49 7	24 9
1981	87 9	45 1	22 8
1982	83 9	40 6	20 8
‡1983	86.5	40 1	19 4

*On a national income and product account basis

†Total revenue equals tax and nontax receipts plus Federal grants Social insurance contributions are excluded

‡Federal Reserve Bank of New York estimates

Source U S Department of Commerce, Bureau of Economic Analysis

Table 2

State and Local Expenditures*

Calendar year	Total expenditures (billions of dollars)	Education	Trans-portation	Income support and welfare†	Housing and community services	Health and hospitals	Other
					(As a percentage of total expenditures)‡		
1952	24 9	33 3	18 5	13 7	5 2	9 2	20 1
1955	32 2	37 0	18 9	12 1	3 7	8 4	19 9
1960	48 7	37 8	18 3	11 5	3 9	8 2	20 3
1965	73 5	41 0	16 5	11 0	3 7	8 0	19 9
1970	131 2	41 5	13 2	14 6	2 8	8 4	19 6
1971	147 9	41 0	12 4	15 5	2 6	8 7	19 9
1972	162 1	40 9	11 7	15 9	2 3	8 7	20 6
1973	178 3	41 2	11 2	16 0	2 5	8 8	20 3
1974	200 9	40 7	11 6	15 1	2 7	9 2	20 7
1975	228 5	40 7	10 2	15 5	3 0	9 0	21 5
1976	247 3	40 6	8 9	15 9	3 0	9 0	22 6
1977	265 6	40 5	8 4	16 0	3 0	9 2	22 8
1978	293 0	39 9	8 7	15 5	3 6	9 4	22 9
1979	317 9	40 4	9 0	15 2	3 6	9 6	22 2
1980	352 8	40 2	9 2	15 5	3 6	9 8	21 8
1981	381 1	39 9	9 0	15 7	2 9	10 0	22 4
§1982	406 0	39 9	9 1	16.0	3 3	10 2	21 5
§1983	430 5	39 8	9 2	16 2	3 6	10 4	20 8

*On a national income and product account basis. Data for state and local expenditures by category are not available on a NIPA basis prior to 1952
†Includes medicaid ‡Figures may not sum due to rounding
§Federal Reserve Bank of New York estimates

Table 3

Composition of Federal Grants to State and Local Governments*

Calendar year	Total grants (billions of dollars)	Education	Trans-portation	Income support and welfare†	Housing and community services	Health and hospitals	Other‡
					(As a percentage of total Federal aid)§		
1952	2 7	7 5	18 5	57 8	0 3	4.4	11 5
1955	3 2	8 0	22 9	55 8	1 2	3 1	9 0
1960	6 5	6.3	38 7	40 2	2 1	4 7	8 1
1965	11 1	7 5	35 1	37 7	4 4	6 4	8 9
1970	24 5	15 0	19 4	42 1	7 4	5 3	10 7
1971	29 0	13 5	17 9	44 5	7 9	4 9	11 3
1972	37 5	11 8	13 8	44 2	6 8	4 0	19 4
1973	40 6	9 7	12 2	35 9	6 9	5 1	30 2
1974	43 9	11 3	12 9	35 5	8 7	5 6	25 9
1975	54 6	10 2	12 8	37 5	8 6	4 7	26 2
1976	61 1	7 4	12 1	39 1	9 7	4 5	27 2
1977	67 6	8 1	11 2	38 2	9 6	4 2	28 8
1978	77 3	7 9	11 1	36 9	8 1	3 8	32 3
1979	80 5	9 0	12 7	38 2	9 7	3 6	26 9
1980	88 7	8 9	13 6	40 5	10.0	3 7	23 3
1981	87 9	9 0	13 3	45 4	9 4	3 9	19 0
‖1982	83.9	9 4	13 0	47 4	10 7	4 1	15.4
‖1983	86 5	9 1	13 5	49 6	11 5	3 9	12 4

*On a national income and product account basis. Data for Federal grants by category are not available on a NIPA basis prior to 1952
†Includes medicaid ‡Includes revenue sharing §Figures may not sum due to rounding
‖Federal Reserve Bank of New York estimates
Sources for Tables 2 and 3 U S Department of Commerce, Bureau of Economic Analysis

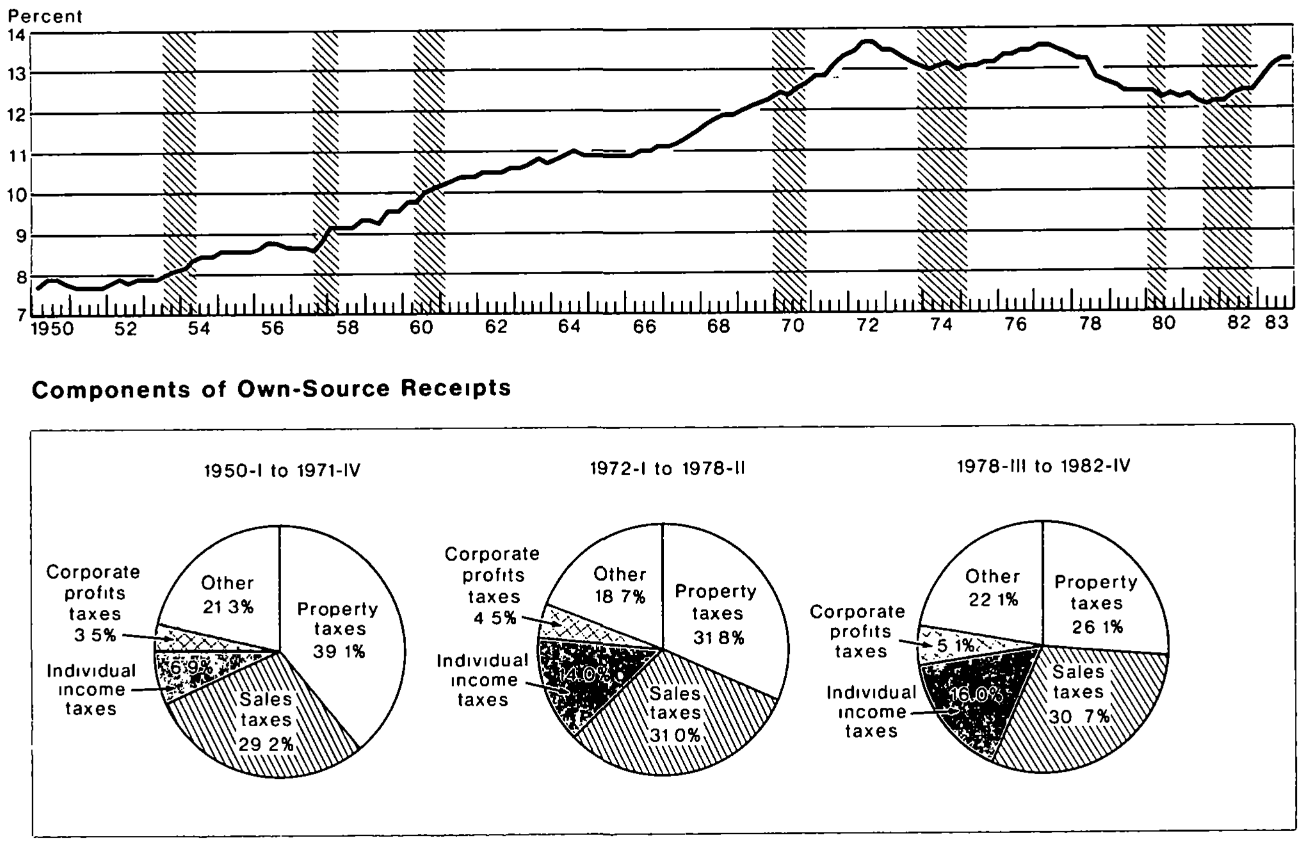
grants occurred, and the growth of expenditures slowed By 1977 the state and local sector had an operating budget surplus of over $10 billion. At the time, it was the largest one the sector had ever run

The end of this second phase marked a critical turning point for state and local governments Financially, the sector, as well as the individual governments, had never been better off In spite of that, a number of factors were complicating the budget decisions facing state and local policymakers One was that state and local taxes were near record levels as a share of personal income (Chart 3) At the same time, though, state and local governments were not providing increasing levels of goods and services in real terms Their purchases were at a ten-year low in relation to real GNP, and in 1976 and 1977 their real per capita purchases fell for the first time in the postwar period Between 1950 and 1975 real per capita purchases had risen steadily from $375 to $840, but by 1977 they were down to $824 Finally, states and localities continued to be highly dependent on grants at a time when the Federal Government was running its largest deficits to date

In many respects, state and local governments were confronted with the same set of circumstances in 1977 as they are now. At issue was the extent to which they should reduce taxes, increase spending, or maintain large balances. Their ensuing decisions brought about the most sweeping changes in the fiscal profile of the state and local sector in history The outcome of those decisions also provide the basis for the two sets of

Chart 3

State and Local Own-Source Receipts as a Percentage of Personal Income



All figures are on a national income and product account basis Shaded areas represent periods of recession as defined by the National Bureau of Economic Research

Source U S Department of Commerce, Bureau of Economic Analysis

concerns regarding the policy decisions state and local governments face today.

In the third phase, from 1978 through 1982, three different types of events had a substantial impact on the state and local sector—"the tax revolt", a sharp cutback in Federal aid, and two recessions.

The tax revolt was more than likely due to the combination of circumstances surrounding the financial position of state and local governments in 1976 and 1977 rather than to any one of them. The movement was ushered in by Proposition 13 in California in June 1978 That legislation was specifically designed to reduce property taxes. It received much of its impetus, though, from the state's $4 billion budget surplus which enabled taxes to be cut without necessarily requiring the provision of goods and services to be reduced as well

Between 1978 and 1980, many other state and local governments, also running high surpluses, cut taxes and placed a ceiling on the rates of growth of own-source receipts and spending by indexing them. In most cases, the rates of growth of specific tax receipts and expenditures were indexed to the growth of personal income, the assessed value of property, or the growth of population. From 1978 to 1980, thirty-two states enacted a total of fifty-four reductions of a major tax. Most of their efforts were aimed at the individual income and general sales taxes. Local governments concentrated primarily on the property tax.

The impact of the tax revolt on the scope of state and local economic activities was immediate and substantial. From 1978 to 1980, the tax cuts reduced state and local own-source receipts by about $13.6 billion.[5] They also led to a deceleration in the growth of expenditures. For the first time in the postwar period, total revenues and expenditures at the state and local level declined on a sustained basis relative to the general government (Chart 1) and to GNP (Chart 2). State and local own-source receipts fell to a ten-year low as a share of personal income (Chart 3).

When state and local governments cut the effective rates in the general sales and individual income taxes, they also dampened the responsiveness of each tax to inflation. Between 1978-III and 1980-IV, for instance, the average rate of inflation in the United States was over 9 percent, as measured by the GNP deflator: At the same time, the consumer price index rose by an average of over 12 percent. Yet, for state and local governments, individual income tax receipts remained flat and general sales tax receipts fell with respect to personal income

From 1979 to 1982, attempts by the Federal Government to reduce its budget deficit led to a reduction of grants to states and localities in real terms first and then in nominal terms as well (Table 1). By 1982, real Federal aid was less than it had been in 1975. As a share of state and local revenue, grants had fallen to 20.8 percent, the lowest amount in eleven years The discontinuation of Federal revenue-sharing funds for state governments in 1981 was the major change in the makeup of grants. As shown in Table 3, it was offset by an increase in the portion of aid going to income support and welfare programs.

The decline in grants intensified the squeeze on state and local revenues initiated by their own tax cuts. However, state and local governments replaced only a small percentage of lost Federal funds with their own-source receipts. Ultimately, then, the cuts had a greater effect on reducing the growth of both revenues and expenditures for state and local governments than they had on the severity of their financial problems.

The first quarter of 1980 marked the beginning of state and local government financial troubles as the economy fell into a recession. By the second quarter of the year, the overall sector had registered its smallest aggregate surplus in four years (Chart 2). In contrast to the sector's deficits between 1950 and 1971, the decline in the NIPA surplus in 1980 signaled the beginning of financial problems for individual state and local governments as well. At the state level, for instance, governments opened fiscal 1980 with a balance of $11 2 billion left over from fiscal 1979. By the end of fiscal 1980, the balance was $11.3 billion, indicating that state operating budgets ran an aggregate surplus of only $0 1 billion

The four quarters of recovery following the 1980 recession did little to ease the financial pressure on state and local governments.[6] In addition to the loss of receipts from the tax cuts, indexation had reduced the potential revenue gains from inflation. At the end of fiscal 1981, just prior to the start of the second recession, sixteen states had either a deficit or a balance equal to less than 1 percent of outlays [7]

The recession from 1981-III through the end of 1982-IV left the state and local sector in its worst financial position in six years (Chart 2). Three states ended fiscal 1982 with a deficit. As a share of outlays, the balance

[5]Federal Reserve Bank of New York estimate The Tax Foundation has estimated that tax cuts enacted solely by states from 1978 to 1980 amounted to about $4 billion Over the same three years, figures from the Bureau of Economic Analysis show that, for selected taxes at the state and local levels, the cuts were worth roughly $9 5 billion

[6]The recovery ended in the second quarter of 1981, the same time that fiscal 1981 ended for all but four states

[7]All survey data on the financial condition of state governments at the end of a fiscal year reported in this article were obtained from the National Conference of State Legislatures

in fifteen other states was no greater than 1 percent. In fact, only thirteen states did not face financial problems as they ended the year with balances of 5 percent or more Conditions at the local level were only somewhat better.

Since the recovery was widely expected to begin by the middle of 1982, most state and local governments formulated their fiscal 1983 budgets on that basis As the recession persisted throughout 1982, though, it became apparent that many budgets would have to be altered to avoid ending the year with a deficit Once again, taxes were raised and the growth of spending was restrained. Nevertheless, eleven states still recorded deficits in fiscal 1983 As a percentage of outlays, balances in fifteen states were 1 percent or less and no more than 3 percent in fourteen others Only nine states had a balance equal to 3 percent or more of outlays

In response to their deteriorating financial position, state and local governments adopted strict austerity measures. From the beginning of 1981 to the end of fiscal 1983, they raised taxes by over $18 billion[8] They also placed further restrictions on the growth of spending.

At first, the taxes that states raised were not the same ones they cut between 1978 and 1980. As a rule, states raise their general sales tax or individual income tax only as a measure of last resort. Of the seventy-five tax increases enacted by thirty-five states during fiscal 1981 and 1982, fifty-four were for excise taxes and half of those were for the gasoline tax. As their financial positions worsened through fiscal 1983, though, many states were forced to turn to a broad-based tax for additional revenue. Between 1981 and 1983, twenty-six states raised their general sales tax, their individual income tax, or both. The result was the most significant increases in these taxes since 1965-71. Back then, however, the goals were to broaden tax bases and to reduce the burden of local property taxes.

The structure of the corporate income tax was probably altered more than any other tax at the state level during this period. The Accelerated Cost Recovery System (ACRS) contained in the Economic Recovery Tax Act of 1981 greatly liberalized depreciation allowances and reduced Federal corporate income tax liabilities.[9] Since all states except California had been following the Federal depreciation standards, they also stood to lose a large percentage of their corporate income tax receipts. To avoid that loss, twenty-one states either partly or fully decoupled their systems from Federal depreciation standards while four others raised the corporate income tax rate.

At the local level, some governments raised the property tax following the 1980 recession and well into the 1981-82 downturn. More often, though, localities increased the individual income tax, sales taxes, user fees, or a variety of other taxes and charges to raise revenue.

On balance, then, there were two distinct sets of policy combinations at the state and local level from 1978 through 1982. The first one, applied between 1978 and 1980, contained reductions of both taxes and the growth of expenditures. In the second one, pursued from 1981 through 1982, there was an abrupt reversal in aggregate tax policy, but the stance on spending remained the same. Starting in 1978 and continuing through 1983, both sets of fiscal policies had a significant effect on the performance of the U.S. economy.

Economic impact of state and local fiscal policies

As a first step in examining the effects of state and local fiscal policies on the 1980 and the 1981-82 recessions, it is useful to look at how the aggregate components of real GNP have varied during each of the eight postwar recessions. Table 4 shows the changes in real GNP from the preceding peak to the trough of each recession as well as the underlying changes in real consumption, investment, net exports, and government purchases.

In the first six recessions after World War II, state and local government purchases stand out as the one component of real GNP that always served to reduce the magnitude of the downturn The two most recent recessions were a departure. In 1980, state and local purchases in real terms registered their first postwar decline during a recession In the 1981-82 downturn they increased by only $0.2 billion. This last recession was also unique in comparison to the other postwar recessions in that it contained the largest decrease in real Federal grants and the largest increase in real Federal purchases

Focusing on the changes in the real purchases of state and local governments, though, gives an incomplete picture of the effect the sector had on past recessions For example, the breakdown of figures in Table 4 makes it tempting to conclude that state and local governments exacerbated the 1980 recession and had virtually no effect on the most recent one. The following analysis, however, shows that both conclusions are incorrect The reason is that the additional economic effects caused by changes in state and local tax policies and Federal grants are excluded in Table 4

[8]Federal Reserve Bank of New York estimate For the full three-year period from 1981 through 1983, the Tax Foundation estimated that tax increases at the state level were worth more than $14 billion

[9]It was estimated that the Federal Government would lose 40 percent of its corporate income tax receipts by 1986 as a result of the provisions in ERTA

The changes in state and local governments' tax policies had an impact on both their real purchases and on certain economic variables which, in part, determine several other components of real GNP. For instance, when state and local governments rebuild their balances during a recession by raising taxes, disposable income is reduced and, other things being equal, real consumption is lowered. Furthermore, not all the changes

Table 4

Changes in the Components of Real GNP in the Eight Postwar Recessions*

In billions of 1972 dollars, seasonally adjusted annual rates

Real GNP and its components	1981–III to 1982–IV	1980–I to 1980–III	1973–IV to 1975–I	1969–IV to 1970–IV	1960–II to 1961–I	1957–III to 1958–II	1953–II to 1954–II	1948–IV to 1949–IV
								Eight postwar recession periods
Real GNP	−45 1	−32 2	−61 8	−0 9	−0 7	−18 6	−20 2	−7 1
Personal consumption	16 7	−8 9	−3 4	10 0	−0 1	−0 5	1 6	7 1
Nonresidential investment	−16 5	−8 2	−20 0	−7 1	−2 6	−8 5	−1 1	−8 2
Inventory investment	−38 8	−9 6	−38 0	−5 6	−7 4	−9 9	−9 2	−13 0
Federal purchases	12 6	0.3	0 6	−11 6	2 2	2 5	−19 4	0 2
State and local purchases	0 2	−0 3	6 1	7 5	4 8	4 8	4 7	6 4
Net exports	−16 8	3 6	10 9	1 8	3 6	−6 3	2 3	−2 3
Addendum:								
Real Federal grants to state and local governments	−4 0	0 1	2 4	2 2	0 8	2 1	−1 1	0 3

*Changes are expressed as the first difference from the peak to the trough of each recession

Source U S Department of Commerce, Bureau of Economic Analysis

Table 5

Sources of Change in State and Local Government Revenues and Expenditures

In billions of dollars, seasonally adjusted annual rates

Sources of change	**Period 1** 1978–III to 1980–IV	**Recession** 1980–I to 1980–III	**Period 2** 1981–I to 1983–IV	**Recession** 1981–III to 1982–IV
In revenues	68 5	12 4	82 7	25 8
Due to				
Discretionary policy	−13 6	−3 3	21 4	14 3
Federal grants	15 2	3 3	−4 0	−1 4
*All other	66 9	12 4	65 3	12 9
In expenditures	67 2	15 3	68 1	33 1
Due to				
Discretionary policy	−7 2	−0 6	−2 8	−6 5
†Federal grants	22 9	4 3	1 6	1 8
*All other	51 5	11 6	69 3	37 8
In real purchases (1972 dollars)	2 6	−0 3	−2 0	0 2
Due to				
Discretionary policy	−2 4	−0 8	−0 9	−3 3
†Federal grants	3 0	−0 6	−6 8	−0 4
*All other	2 0	1 1	5 7	3 9

*These are due primarily to changes in both real and nominal economic conditions Demographic factors also have a small impact

†Includes both the actual change in grants plus the induced changes in expenditures due, for example, to matching requirements for state and local governments

Source Federal Reserve Bank of New York estimates in state and local governments' real purchases were due to discretionary action on their part. A portion of the changes came about because of the cutbacks in Federal grants.

In assessing the total impact of the state and local sector on the last two recessions, then, it is important to isolate the effects attributable to state and local discretionary tax and expenditure policies, Federal grant policies, and economic conditions. Otherwise, misleading conclusions could be drawn as to whether or not the actions of state and local governments were countercyclical or if they supported Federal efforts at restoring economic recovery. For purposes of evaluating fiscal policies at all levels of government, this distinction is crucial.

The changes in revenues, expenditures, and real purchases of state and local governments due to their own discretionary policies, the level of Federal grants, and all other factors are presented in Table 5.[10] Two time periods are analyzed. The first, from 1978-III to 1980-IV, corresponds to the period in which state and local taxes were being cut and the growth of spending was restrained following the tax revolt. This period includes the recession from 1980-I to 1980-III. In the second period, from 1981-I to 1983-IV, state and local taxes were raised and, at least through the beginning of 1983, spending was further restrained. The six quarters from 1981-III to 1982-IV is the recession in which this second mix of policies was pursued.

The overall impact of state and local governments' discretionary policies from 1978-III through 1980-IV was expansionary, as they reduced taxes by more than they reduced spending. During this time, Federal grants increased in nominal terms but fell in real terms. Even so, the changes in state and local governments' expenditures resulting from the change in grants were positive, as many of them failed to anticipate fully the extent of the grant cutbacks when planning their budgets.

Only a small portion of the expansionary effect of state and local fiscal policies between 1978-III and 1980-IV was felt during the 1980 recession. The decline in revenues due to the tax cuts had slowed, and the cuts just outweighed the discretionary reductions of expenditures and real purchases. Federal grants were not a significant factor in determining the sector's total revenues and expenditures.

In the second period, from 1981-I to 1983-IV, state and local discretionary policies were clearly contractionary. The wave of tax increases generated over $21 billion in additional receipts. Moreover, the limits and absolute cuts in spending continued to reduce expenditures and real purchases. The Federal Government reinforced the impact of state and local policies throughout the period. As grants declined in real terms in 1982 and 1983, so did the state and local purchases tied to those funds.

The contractionary effects of state and local government policies were especially strong during the 1981-82 recession. Revenues grew by over $14 billion as a result of discretionary tax increases At the same time, state and local government spending policies led to a reduction of $6.5 billion in expenditures. Over the course of the downturn, real state and local purchases averaged about 11 7 percent of real GNP, the lowest since 1965.

Near-term outlook

A new phase in the fiscal profile of state and local governments may now be under way Their recent tax increases provided a strong boost to revenues, and most of them continued to hold the line on spending. In addition, the recovery was stronger than most analysts and policymakers had originally expected. As a result, by the end of calendar year 1983, the state and local sector as a whole registered a large operating surplus for the third consecutive quarter (Chart 2). Furthermore, a survey of state budget offices revealed that only three states anticipate deficits for fiscal 1984.[11]

In spite of their improved financial conditions, state and local governments still face a number of difficult decisions in planning their budgets over the next several years. This is because the same set of troubling circumstances existing in 1976 and 1977 exist today

- By postwar standards, the state and local sector's surplus is the largest ever. State and local

[10]The figures in Table 5 were derived from a ten-equation quarterly econometric model of the state and local sector estimated by the author The model is patterned after the specification of the state and local sector in the Federal Reserve-MIT-Penn (FMP) model and was estimated using NIPA data The model works as follows First, total state and local spending is determined from equations estimated for employee compensation, structures, other purchases, and transfer payments The explanatory variables for these expenditure equations include measures for personal income, relative prices, interest costs, population, unemployment, Federal grants, and lagged expenditures Next, the portion of expenditures that would have to be financed through state and local own-source receipts is estimated, defining the sector's net revenue requirement Then, each component of state and local own-source receipts is expressed as a share of the total and estimated as a function of personal income, household wealth, corporate profits, inflation, and the change in the net revenue requirements By estimating each component as a share of the total net revenue requirement, the sector's budget constraint is imposed The components for own-source receipts include the individual income tax and other taxes, sales taxes, indirect business taxes (includes the property tax), and the corporate profits tax

[11]Steven Gold and Corina Eckl, *State Fiscal Conditions Entering 1984* (National Conference of State Legislatures, Denver, Colorado, 1984)

governments' taxes are as high as they have ever been with respect to personal income, and their real purchases are at a 21-year low as a share of real GNP.

- In 1983 the Federal Government ran its largest unified budget deficit in history—$195.4 billion, or 6 1 percent of GNP. Under current policies, the Federal deficit is expected to average over 5 percent of GNP throughout the rest of this decade. By 1989, this could amount to approximately $300 billion

State and local policymakers are certainly aware of these circumstances and, given their experiences since 1978, are attempting to prepare for them. In some cases, their preparations involve rather new and innovative policies [12] For example, twenty states now have "rainy day" or "budget stabilization" funds Many of these were established in the last several years. States can draw upon these funds during lean economic times and rebuild them during prosperous times Some states are also considering the adoption of "trigger" taxes that go into effect automatically if budget problems arise.

Just how well prepared state and local governments are should be tested soon. For instance, the recent tax increases which led to the sector's current surplus could be scaled back over the next few years Although thirteen states raised their individual income tax in 1983, the increases were only temporary in seven of those states and will expire in either 1984 or 1985. Five of the fourteen general sales tax increases enacted in 1983 will expire during 1984 Finally, if voters believe that the Federal deficit will be reduced by higher taxes, they may call for an offsetting reduction of state and local taxes.

On the spending side of their budgets, state and local governments may find it increasingly difficult to hold the line on the growth of expenditures. In the immediate term, pressure to increase expenditures will come from the area of education and from state and local employees who, in the past few years, have settled for either partial wage adjustments or none at all.

Perhaps the most serious circumstance facing state and local governments is what may be the most significant infrastructure financing needs in their history. The bulk of the expenditures related to the capital projects they undertake will be financed by issuing debt. Even so, state and local current operating budgets may have to be adjusted to cover additional expenditures related to infrastructure projects or a portion of the interest costs from the increased borrowing.

Identifying infrastructure financing needs and projecting the potential costs is difficult. Nevertheless, the Congressional Budget Office estimates that, from 1984 to 1990, annual capital outlays by all levels of government will have to be about $28 billion for repairs, rehabilitation, and replacement on existing infrastructure systems.[13] To meet growing demands on existing systems, they estimate an additional $25 billion will be needed each year for new construction That totals to nearly $375 billion over the seven-year period.

Presently, Federal, state, and local governments spend about $36 billion a year for capital outlays. Under current policy, the Federal Government would finance about half of the estimated additional needs. That share could fall below half, though, if the Federal Government decided to reduce its deficit by limiting its involvement in funding infrastructure projects. How state and local officials restructure their borrowing, taxing, and expenditure policies to finance the remaining portion could be their most severe test of all.

Concluding remarks

Any examination of fiscal policy in the United States excluding state and local governments is incomplete. State and local fiscal policy actions have had a particularly significant impact on the economy during the past five or six years. In view of the budget decisions state and local governments must make in the next few years, their actions will in all likelihood continue to be an important factor in economic growth.

What this suggests is that, for purposes of macroeconomic analysis and policy, we must consider the economic activities of all levels of government: Federal, state, and local. Too often, only Federal financial problems and policy decisions are evaluated. Certainly, one of the most critical issues over the near term will be selecting a course for the Federal budget. However, given the interrelationships between Federal policies, the economy, and state and local financial conditions, the course which is eventually chosen could have a substantial bearing on the direction of state and local fiscal policies as well. Recognizing this, and incorporating it into the decision-making process, would be an important first step toward coordinating fiscal policies across all levels of government.

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[12] For a more detailed discussion of these policies, see Steven Gold, *Preparing for the Next Recession Rainy Day Funds and Other Tools for States* (National Conference of State Legislatures, Denver, Colorado, 1983)

[13] Congressional Budget Office, *Public Works Infrastructure Policy Considerations for the 1980s* (Washington, D C , April 1983) All cost estimates are in 1982 constant dollars