State and Local Finance

By Robert S. Ford

FOR a number of years prior to World War II, state and local expenditures ranged between 10 and 15 per cent of the national income and accounted for about 50 per cent of total governmental expenditures. Such figures offer striking testimony as to the significance of these two levels of government. In these days of huge budgets for the National Government there is need to re-emphasize the importance of non-Federal fiscal activities.

It is a well-known fact that Federal finance assumes the major role in periods of war. In 1913 state and local governments accounted for 72 per cent of the total $2.5 billion of government spending. During World War I Federal expenditures catapulted and even in 1919 represented 87 per cent of the total amount spent by all units. By 1932 state and local spending had risen to 65 per cent of the over-all $13 billion total. Although the state and local proportion declined during the depression and the era of the New Deal, they still accounted for 50 per cent in 1935 and in 1940. During World War II the experience of the First World War was repeated, with Federal expenditures rising to 89 per cent of the $112.5 billion spent in 1945. The relative fiscal importance of state and local governments rose again after the war and in 1947 represented 28 per cent of the total $59 billion in government spending.

It is likely that expenditures of the National Government will continue at a high level for many years because of the financial obligations to veterans, the insecurity in international affairs, and the payments incident to a $250 billion debt. They will also be affected by the trend in economic conditions. On the other hand, indications are that the level of state and local spending is considerably above that in 1947, and it will continue to rise if the national income remains high.

With this background on the comparative role of the various levels of government, we shall now turn to a brief characterization of state and local expenditures and the development of their tax systems.

Nature of State and Local Expenditures

The 48 states and 155,000 units of local government finance and administer a wide range of activities, most of which involve frequent and close contacts with the average citizen. These include education of our youth in the public schools and in many universities and colleges, construction and maintenance of arterial highways and local roads and streets, police and fire protection, financial assistance for the indigent and the unemployed, care of mentally afflicted and tuberculous persons, protection of the public health, and other activities too numerous to mention.

A mere listing of the chief types of services performed at the state and local levels suggests that expenditures for these purposes are relatively inflexible. Whether we have prosperity or depression, war or peace, the need continues for education, public health and sanitary regulation, police and fire protection, and care of the afflicted and handicapped. A large part of state and local expenditures are made for these purposes. In 1942, which is the latest year for which complete figures are available, about 33 per cent of total operating costs were for schools, 29 per cent were for hospitals, public welfare, correction, and health, and 10 per cent for police and fire protection. These activities, which cannot be readily contracted, accounted for 72 per cent of total operating costs.

Although the demand for these particular services is relatively inelastic, total state and local expenditures tend to expand in prosperous times and to contract in depressions. Ordinarily, the increase is chiefly attributable to expansion of plant and facilities for highways, school buildings, hospitals, and so forth. The larger plant necessitates a higher level of operation and maintenance charges, and as a result the decrease during a depression will not ordinarily be as great as the preceding increase. Moreover, such expansion is usually financed by borrowing, and payments on principal and interest must be met in later years. Debt service constitutes an important factor in state and local budgets, having amounted to about 14 per cent of total expenditures in 1942.

A significant item for the states is that of financial assistance to local units in the form of grants-in-aid and state-collected locally shared taxes. For 1948 the United States Census Bureau reports that these transfer payments amounted to $3.2 billion including Federal grants to states,[1] which was about 30 per cent of total expenditures of all states. As a transfer agency, no other level of government is as important as the states. These funds are turned over to local units primarily for the financing of schools, highways, and welfare. The transfer payments of local units consist for the most part of interest on debt and aid to the indigent.

DEVELOPMENT OF STATE AND LOCAL TAX SYSTEMS

Some of the chief problems confronting state and local governments can be more easily understood in the light of historical perspective. It seems pertinent, therefore, to review briefly some of the high points in the development of the tax systems at these two levels.

State

Historically the property tax was the backbone of both state and local systems, providing practically all the tax revenue of local units. After the First World War the need for additional revenue led to some diversification, with six or seven states adopting the personal income tax and about one-fourth of them adopting the inheritance tax or imposing it on direct heirs for the first time. Of greater significance than the new taxes were the efforts to correct some of the inequities of the property tax and to increase revenues from this source. Chief examples of this were the inauguration of better assessment practices and procedures, adoption of the classified property tax by a number of states, and the segregation of intangibles for low-rate taxation.[2]

The decade of the 1920's was marked by a great increase in tax revenues from motorists, in all the states. Four states enacted a personal income tax, bringing the total to fourteen in 1929. Severance taxes on the extraction of minerals and crude oil were also imposed by a few states. Another significant

[1] In 1948 the states received $1.4 billion from the Federal Government. U. S. Bureau of the Census, *Summary of State Government Finances in 1948,* State Finances: 1948, No. 1 (May 1949), p. 2. Some of this was used for state functions and not returned to local units.

[2] Carl Shoup, Roy Blough, and Mabel Newcomer, *Facing the Tax Problem* (New York: Twentieth Century Fund, 1937), pp. 33 f., 40 f., 45.

development in that period was the initiation of the state sales tax movement when West Virginia adopted a gross sales tax in 1921. There were no other adoptions until 1929, when Georgia and Mississippi imposed taxes of this general character.

Profound effects on state tax systems were exercised by the depression of the 1930's. With the collapse in real estate values and the sharp decline of income during those years, property tax delinquency rose to unprecedented proportions. A number of states either dropped their levy on real estate or reduced it sharply, thereby making it primarily a local tax.

In 1933 the sales tax movement developed into a "stampede," with twelve states adopting it primarily to provide increased financial assistance to local units as a means of relieving the property tax burden, and to obtain funds for state participation in the Federal program of welfare and relief. The personal income tax also spread rapidly during those years, with its adoption in 15 additional states, bringing the total to 29 in 1937. A similar increase occurred in the number of states imposing an income tax on corporations. Following the repeal of prohibition in 1933, most states enacted some type of liquor tax. Initiation of the Federal social security program in 1935 led to the adoption of state pay-roll taxes in order to participate in the plan for unemployment compensation and old-age and survivors' insurance.

The taxes that have been listed above provide the framework within which state tax systems have developed. No important new taxes have been introduced in recent years, and the changes have been principally in wider adoptions or changes in the rates of existing taxes.

In 1948 five types of revenue sources provided 73 per cent of total state revenues from taxation. In that year, out of total tax collections of $6.8 billion (excluding the $1 billion in pay-roll taxes), 22 per cent came from retail sales (21 states) and gross receipts (11 states) taxes; 19 per cent came from the tax on motor vehicle fuel (all states); 16 per cent was derived from the corporate and personal income taxes (34 states); motor vehicle and operators' licenses (all states) produced 9 per cent of tax revenues; and alcoholic beverage sales and licenses (all states) accounted for 7 per cent.[3]

Local

Local tax systems are based largely on the general property tax. Under the impact of the depression, however, the tax on real estate practically collapsed in many localities. Property tax delinquency was very high throughout the entire country, the average for all states being 20 per cent on the state and local levy for 1932–33.[4]

Local governments found it impossible to obtain sufficient revenue from this source, and indeed it seemed that the upper limit of the property tax had been reached. While some of the cities adopted other taxes, this was not feasible for most units, and the only alternative appeared to be an increase in state and Federal grants-in-aid.

The growth in state financial assistance after 1932 is one of the outstanding features in state and local finance. While revenue from the local property tax was approximately the same in 1942 and 1932—namely, $4.5 billion—state aid doubled and rose from $915 million to $1.8 billion. This includes

[3] Commerce Clearing House, Inc., *Tax Systems, Eleventh Edition* (Jan. 1948). Percentages computed from data contained in *Facts and Figures on Government Finance, 1948–49* (New York: The Tax Foundation), p. 73.

[4] U. S. Bureau of the Census, *Realty Tax Delinquency* (1934), Vol. I, pp. 6 f. and *passim*.

both grants and shared taxes, which are not reported separately by the Census Bureau, as well as Federal funds. By 1946 state aid had risen to $2.1 billion, and in 1948 it amounted to $3.2 billion.[5]

Between 1932 and 1947 local units were also developing a number of miscellaneous charges and taxes, although the yield was not large—$379 million in 1946. This trend, however, turned into a major development in 1947, with action being taken on a state-wide basis in a number of states. Municipalities all over the country are adopting various kinds of taxes, licenses, and special charges. These include income taxes, which have become especially popular in Pennsylvania; retail sales taxes, which have been particularly appealing in California; business and occupation licenses; taxes on amusements, public utilities, cigarettes, alcoholic beverages, and hotel rooms; parking meter fees; and so forth.[6] In all instances they are predicated on the fact that local taxes supplementary to the property tax are necessary and that funds from state aid and shared taxes are insufficient.

STATE AND LOCAL PROBLEMS

From the preceding material it is evident that state and local governments are faced with budgetary problems of considerable magnitude. Many of these problems are economic in character, some are attributable to social changes, while others are more or less of a political nature. More specifically, they arise out of the difficulty of obtaining sufficient revenues to finance the increase in governmental activities, the difficulty of controlling public expenditures, the complexity of the local government structure, the wide variations in economic resources within units of government, and the development of intergovernmental fiscal and administrative relationships. This is an imposing array of problems, and it is not the intention to consider them here. Many of the issues involved can be summarized and brought to a focus in three problems connected with state and local tax systems, the growth of state aid, and fiscal policy, which will now be considered.

State and local tax systems

There are thousands of local tax systems in the United States—cities, villages, counties, townships, and so forth —in addition to the 48 state systems. While not all of the 155,000 local units constitute separate taxing districts, they are revenue-raising and spending units by virtue of their authority to levy special assessments, to determine and collect utility rates, or to receive revenue that some other unit of government must raise and turn over to them for expenditure. Local tax systems present a highly decentralized pattern, which is a reflection of the heterogeneous structure of local government consisting of approximately 16,000 incorporated places, 3,000 counties, 19,000 towns and townships, 109,000 school districts, and 8,000 special districts.[7] Many of these units are not large enough in terms of population and taxable capacity to provide services in

[5] U. S. Bureau of the Census, *Historical Review of State and Local Government Finances*, State and Local Government Special Studies No. 25 (June 1948), p. 13; and Census Bureau, *Summary of State Government Finances in 1948*, *op. cit.*, p. 2.

[6] International City Managers Asso., *The Municipal Year Book 1948* (Chicago), p. 179; Calif. State Board of Equalization, Division of Research and Statistics, *More City Sales Taxes* (March 1, 1949), p. 1; Chester B. Pond, "Municipal Taxes on Selected Commodities and Services," *Bulletin of the National Tax Association*, Vol. XXXIII, No. 2 (Nov. 1947), pp. 40–45.

[7] U. S. Bureau of the Census, *Governmental Units in the United States, 1942* (1944), p. 9.

an economical and efficient manner. In a large number of states the average citizen is subject to three layers of local government: (1) the county, (2) the city or village (urban) or township (rural), and (3) the school district. Under these circumstances there is obviously no such thing as a typical local tax system.

The states likewise present a high degree of diversity, either through the variety of taxes imposed or through the relative reliance placed on certain major taxes. In general, the means of financing state government can be seen from the relative importance of various taxes for all states, which was listed previously, but it does not illustrate a typical system.

The relatively inflexible character of state and local services and expenditures has made it necessary to place the emphasis on stability in the selection of revenue sources. Consequently, state and local tax systems are based largely on sales and excise taxes, gross income taxes, property taxes, licenses and fees to do business, and similar levies. While these taxes are often criticized because of their regressive character, they are not subject to the highly variable yield of a net income tax. Furthermore, the heavy reliance by the Federal Government on income taxation places certain limitations on the extent to which this can be used as a revenue source for the states.

In the selection of revenue sources the question arises as to whether there should be separation of state and local revenue sources or whether the two should be more closely co-ordinated. When the states relied heavily on the property tax, the state rate was supplementary to and superimposed upon local rates. Local officials collected both the state and the local tax and transferred the state's share to it. Such new taxes as were adopted were collected and used by the states. With the expansion of local tax systems in recent years, the co-ordination problem has again become important.

The short experience with new types of local taxes indicates that large amounts of revenue can be obtained from low-rate local sales and gross income or pay-roll taxes, particularly in the larger cities. However, they have not replaced any local levies, and are simply additions to an already complicated local tax structure. Furthermore, they may eventually create serious problems in the field of intergovernmental fiscal relationships, with the Federal Government and many states imposing a tax on net income. Although such levies are probably not too objectionable as long as the rates are low, many students of the problem do not favor local sales and income taxes.[8]

In passing, reference should also be made to the matter of Federal and state relationships in the selection of revenue sources. This is a highly controversial field, in which many types of recommendations have been made. It will suffice merely to point out that the Federal tax system must also be considered in any comprehensive analysis of state and local problems.[9]

Growth of state aid

Another important problem arises in connection with the growth of state aid to local units, which in 1948 accounted

[8] See for example the Report of the Joint Committee of the American Bar Association, the National Tax Association, and the National Association of Tax Administrators, *The Coordination of Federal, State and Local Taxation* (1947), pp. 99, 101; and William J. Shultz and C. Lowell Harriss, *American Public Finance* (fifth ed., New York: Prentice-Hall, Inc., 1949), p. 716.

[9] For a significant study of this problem, see the Report of the Joint Committee of the American Bar Association, the National Tax Association, and the National Association of Tax Administrators, *op. cit.*

for 30 per cent of total state expenditures. The grant-in-aid serves a very useful purpose in bridging the gap between the appropriate spending unit and the most efficient tax-raising unit. However, there are potential dangers in grants insofar as they tend to stimulate extravagant expenditure—by supplying funds without directly discernible burden to local taxpayers—and to undermine local responsibility. Furthermore, grants may lead to overexpenditure for the particular functions receiving assistance.

In a large number of states, financial assistance to local units—grants and shared taxes—has increased steadily for the past fifteen years. As a result of this trend, many public officials and citizens are coming to hold the view that beyond a certain point, additional funds for local government should be the responsibility of local units.

The approach to this problem made in the state of New York represents one of the most significant developments in the American states. One of the objectives of the so-called "Moore Plan," adopted in 1946, was to check the indefinite growth of state aid, which took 55 per cent of state taxes in 1946–47. This was to be achieved through establishment of a system of lump-sum grants on a per capita basis in place of the former system of shared taxes. Two stabilization reserve funds were created for state purposes and for local assistance. In the following year the local taxing power was considerably broadened to cope with the wide diversity in local needs. Along with these changes, the extent of participation by the state in financing certain functional grants was revised, with the state increasing its grants for schools and assuming 80 per cent of welfare costs and all the cost of snow removal on state highways.

While shared taxes were discontinued in principle, the counties, excluding those comprising the city of New York, receive appropriations equal to the distributive shares they would have received ordinarily from the gasoline tax and the motor vehicle registration fee. For New York City, the distribution of motor vehicle fuel taxes and motor vehicle license fees is considered as part of the local assistance distribution.[10] The new excises authorized for local units are consumption taxes—retail sales, passenger motor vehicles, admissions to amusements, and so forth. While not expressly provided by law, the income tax is reserved to the state.

One other phase of the state aid problem should be noted. The great bulk of state aid funds are absorbed at the local level by the three functions of education, highways, and welfare. Any significant check, therefore, will have to occur in these areas. It is unlikely, however, that there will be a decrease in the total amount spent for these functions, as all the indications point toward a continued increase.

Thus, a reduction in state aid would have to occur through state assumption of the function or at least of that part of the function in which the state-wide aspect is clearly distinguishable from the local aspect. In the case of public education there is no clear-cut differentiation between the two, although the state interest is strong, with emphasis on local administration. Local and state-wide interests in highways are more discernible in the distinction between local roads and streets and arterial highways, although in most states there is some subsidization of local roads. The state interest seems to

[10] Robert F. Steadman, "Recent Development in State-Local Fiscal Relations in New York State," *Bulletin of the National Tax Asso.*, Vol. XXXII, No. 7 (April 1947), pp. 198–204; New York Dept. of Taxation and Finance, *Annual Report of the New York State Tax Commission*, 1946–47, pp. 19–24.

predominate in the case of welfare, and this is being recognized in a number of states. For example, in New York the state now pays 80 per cent of the costs of public assistance (general relief, old-age assistance, aid to dependent children, and aid to the blind). In Michigan a minimum of 50 per cent of the costs of public assistance (same items as in New York) is paid by the state in all counties, and it may extend up to 100 per cent, depending on local fiscal capacity.

Fiscal policy

In general, state and local financial practices have followed the movements of the business cycle, with taxes, borrowing, and expenditures expanding in good times and contracting during depression. Thus the practices of state and local units have tended somewhat to aggravate cyclical swings in economic conditions. This type of policy has been necessary, however, for a number of reasons.

In the first place, adoption of a counter-cyclical policy would necessitate credit resources which are not available to state and local units. These units stand in sharp contrast to the Federal Government with its control of the currency and credit system. Many state constitutions contain a prohibition against borrowing in excess of some specified low figure. The limit to the amount of debt that can be incurred by local units is usually expressed in terms of some fixed percentage of the assessed valuation of property for tax purposes or of the tax to be levied and collected. Borrowing on favorable terms, therefore, is difficult if not impossible during depression years, because the shrinkage in the property tax makes the municipality a poor credit risk.

In the second place, adoption of a counter-cyclical policy would necessitate a unity of action on the part of all, or at least the most important, states and local units that would be practically impossible to achieve.

Third, the very nature of state and local tax systems in their strong reliance on consumption taxes exercises a restrictive effect on the national economy during depression years. Moreover, the burden of the property tax is more restrictive in hard times, tending to depress real estate values as well as private construction.

In view of these obstacles to counter-cyclical policy at the state and local levels, primarily in the maintenance of expenditures in depression years, greater use of Federal grants-in-aid has been advocated to supplement the state and local tax and credit resources.[11] Another proposal is to keep the local tax rate for debt service at its present level, treating it as a levy for capital improvements to be carried out in bad years. According to this view, adequate allowance from current revenues for a long-range program of capital financing provides "the key to fiscal stability."[12] A third type of proposal involves adoption of a deliberate policy of tax reserves by collecting more revenue than will be spent in prosperous years, placing the surplus in reserves to be drawn upon in maintaining necessary spending in times of depression. The advantages of this plan are that it would promote economic stability, preserve state and local fiscal independence (the lack of which is a shortcoming of Federal grants-in-aid),

[11] Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (New York: W. W. Norton and Co., 1944), p. 68. George W. Mitchell, Oscar F. Litterer, and Evsey D. Domar, "State and Local Finance," *Public Finance and Full Employment*, Board of Governors of the Federal Reserve System, Postwar Economic Studies No. 3, Dec. 1945, p. 125.

[12] Frederick L. Bird, "Municipal Fiscal Policy and the Business Cycle," *Proceedings of the National Tax Asso.*, 1945, p. 212.

and make possible a more equitable state and local tax system.[13]

Some experience is now being gained with the tax reserve plan. As mentioned previously, a partial system of tax reserves has been institutionalized in the state of New York through the creation of a reserve fund for state purposes and one for local assistance. The surpluses built up in good years are set aside for the maintenance of essential government services in years of declining revenues. This was made possible by adoption of a constitutional amendment in 1943 authorizing the legislature to create "funds to aid in the stabilization of the tax revenues of the state available for expenditure or distribution."

CONCLUSIONS

Most of the problems facing state and local governments will have to be dealt with at the state level, or at least the state will have to take the initiative in clearing away the obstacles to solution. This does not mean, however, that the state must accept exclusive responsibility for the solution of local problems. A comprehensive and positive approach requires co-operation and joint participation by both levels.

A few states, of which New York is the outstanding illustration, have adopted a positive approach in coming to grips with the local revenue problem. In some instances (Illinois) the new program involves co-ordination, and in others (New York and Pennsylvania) separation of state and local revenue sources. Under either plan, the issue of state aid versus local taxes is faced and a constructive solution is attempted.

The negative approach is represented by the sales tax diversion plan now followed in Michigan. Little official attention was given to the proposal of a special Tax Study Committee in 1945 to reduce the rate of the state retail sales tax and authorize supplementary municipal sales taxes which would be co-ordinated with the state tax and administered by the state department of revenue. (A similar plan has since been adopted in Illinois.) In 1946 a successful movement was initiated for an amendment to the Michigan Constitution that would force the state to split the sales tax and return about 75 per cent of the proceeds to school districts, cities, villages, and townships. As a result, the state government is now in a difficult financial situation. Chief beneficiaries of the scheme are the school districts, which receive the largest share, and the townships, many of which find it no longer necessary to levy any property tax whatsoever.

A major revision in the system of public finance in any state should not be made too suddenly. The sales tax diversion in Michigan became effective thirty days after the date of its adoption in November 1946. It was therefore necessary to make a drastic change in the system that had developed over the years, with only a month's notice. This is in sharp contrast with the procedure followed by New York in placing the Moore plan in operation, as definite provision was made for a gradual transition to the new program. To cushion the shift to lower or higher grants, a "taper" arrangement provided that the payments to any locality in 1946–47 could not vary more than 10 per cent in either direction from shared tax revenues in 1944. The 10 per cent tapering continues each year until the new level of assistance is reached or until the 1950 census data are available.

None of the new programs offers a full solution to the fiscal problems of state and local government. But they

[13] Louis Shere, "Tax Reserves for State and Local Governments," *Proceedings of the National Tax Asso.*, 1945, pp. 187–95.

do recognize to some extent that these problems must be viewed in their framework of state-local fiscal relationships. From this standpoint it is possible to develop a long-range plan based on recognition of the nature and the costs of necessary services and the need for adequate revenues at each level.

Robert S. Ford, Ph.D., Ann Arbor, Michigan, is professor of economics and director of the Bureau of Government at the University of Michigan. He has also taught at the University of California and Princeton and Columbia universities. He was agricultural economist with the Agricultural Adjustment Administration, 1933–34. He is author of several works in the field of public finance and taxation.