The Changing Fiscal Structure of the State and Local Public Sector: The Impact of Tax and Expenditure Limitations

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What has been the impact of the state and local tax and expenditures limitations (TELs) movement of the 1970s and 1980s? Focusing on the consequences of different types of TELs for revenue and expenditure structure, Philip Joyce and Daniel Mullins offer some interesting findings. They found that the level and share of state and local taxes were influenced in some unexpected ways. TELs imposed on state governments had little or no impact on increasing reliance on general tax revenues sources. Where both state and local governments faced limitations, the consequences were greater for local tax structures than for the state. States characterized by local TELs did show short-term overall declines in both state and local tax levels; in the long term, however, state taxes increased in those states. In the area of state aid to localities, Joyce and Mullins found a link between TELs and increased aid, although the evidence indicates that some increases may be attributed to other forces and trends. Finally, Joyce and Mullins found that with the exception of public welfare expenditures, state-level TELs had little impact on the relative amount each government level spent in various functional categories. Where limitations were imposed on both state and local governments, the state was found to be more reluctant to assume increasing burdens. Joyce and Mullins raise a variety of questions addressing the relationship between TELs and other forces that influence the structure of state and local revenues and expenditures. They also raise issues regarding the "offsetting" effects of different types of TELs, the distribution of state aid, and the impacts of TELs on the structure of local governance.

Throughout the latter half of this century, the state and local public economy has witnessed growth in both absolute terms and relative to that of direct expenditures by the national government, such that it shoulders the primary responsibility for civilian functions in the United States. This, of course, is not new or dramatic information. However, within this state and local sector, recent times have recorded what from year to year might appear to be imperceptible shifts in the distribution of authority and responsibility between state and local governments. Over time, the aggregate effects of these incremental changes carry with them important implications for governance.

The previous two decades have seen a shift in the fiscal structure of state and local governments in the United States. Important developments include: 1) alterations in the distribution of revenue sources (with, for example, a decrease in the percentage of own source revenue financed through the property tax and an increase in user fees and lotteries); 2) vertical shifts in the locus of responsibility for certain functions from localities to states (as occurred in California after the passage of Propositions 13 and 4); and 3) horizontal alterations in the structuring of local governance responsibilities (such as the creation of special purpose governments for the delivery of some local services in response to limits on local indebtedness).

The reasons for and implications of these changes represent an important area of study in understanding governance at the state and local level. With them likely come changes in the responsiveness of government and in the distribution of services and benefits conferred by government. One of the possible contributors to these changes is the state and local tax and expenditure movement. To the degree that these alterations emerge as unintended consequences of restrictions imposed on the state and local public sector, they should be viewed with caution.

Table 1
Number of States Enacting Tax and Expenditure Limits By Dates

	Before 1970	1970-1977	After 1978	Total
Limits on Local Government				
Rate Limits	24	7	4	35
Levy Limits	2	7	13	22
Gen'l Rev./Exp.	0	6	6	12
Assessment	0	2	5	7
Full Disclosure	1	5	8	14
Limits on State Government	0	2	17	19

Source: Compilation by authors from ACIR, *Significant Features of Fiscal Federalism*, 1985 (local limits); and *Significant Features of Fiscal Federalism*, 1990 (state limits).

This article then views these shifts in fiscal structure and responsibility within the context of the wave of state and local tax and expenditure limitations enacted during the 1970s and 1980s. The public finance literature is brimming with evaluations of these limitations. Many, however, focus narrowly on the impact that they have had on the sheer size of the public sector rather than on what are arguably the more significant distributional, vertical and horizontal effects. We will investigate these effects in an effort to determine what the impacts have been in states that have adopted various types of fiscal limitations.

Overview of the Tax Revolt

There are various reasons that have been identified for the development of this most recent variant of tax revolt in the United States. Most have one thing in common—a view that government is too large and has grown beyond the preferences of the voters. Regardless of the specific reasons for the growth of government, limitation movements have been linked to efforts to constrain it. However, support for limitations may occur relatively independently of any public desire to reduce government services. In fact, numerous surveys in states where tax and expenditure limitations have been passed suggest that citizens were satisfied with the level of public services and often desired more but were simply unwilling to pay for them (Brazer, 1981).

The primary target of the tax limitation movement in many states has been the local property tax. This tax, highly visible and lumpy in its method of collection, has been unparalleled in its modern-day ability to raise taxpayer ire (ACIR, 1989).[1] The earliest of present-day efforts at limiting taxing were directed specifically at property taxation. These have been augmented by later limitations on general revenue and expenditures at the local level.

The Advisory Commission on Intergovernmental Relations (ACIR) has classified tax and spending limitations affecting local governments into the following categories (ACIR, 1985):

1. overall property tax rate limits;
2. specific property tax rate limits;
3. property tax levy limits;
4. general revenue limits;
5. general expenditure limits;
6. limits on assessment increases;
7. full disclosure and truth-in-taxation measures.

The stringency of the limitation varies with the type adopted and its specific characteristics. While none of these limits is necessarily binding with respect to the overall revenues or expenditures of local governments, some represent more formidable constraints than do others and all reflect something of the attitude of the public in a given state regarding local spending. With this in mind, limitations can be classified based upon the potential constraint that they imply as a function of not only a physical ceiling but also public sentiment. To facilitate this type of thinking, we have classified local limitations into two categories: "non-binding" and "potentially binding." The seven types of limitations are defined in Panel 1, in the context of their constraining nature.

More recently, there have also been limitations directed specifically at state governments. These include both absolute limitations on revenue and spending and limitations on the size of revenue and expenditure increases.

There are clear trends in the enactment of various kinds of limitations over time. Table 1 categorizes the dates of enactment of these limitations, by type of limit. Local government rate limits are by far the oldest and most prevalent of tax limitations. The enactment of other kinds of limitations is owed in part to the perceived limited success of rate limits in achieving their desired results. In many jurisdictions, rate limits were reportedly circumvented through increasing assessments and alternative sources of revenue. More stringent limitations such as levy limits, assessment limits, and general revenue and expenditure limitations grew out of an interest in providing more binding constraints. Table 1 also shows that limits on state government revenue and spending are a relatively recent phenomenon, with 17 of the 19 limitations having been enacted since 1978.

[N]umerous *surveys in states where tax and expenditure limitations have been passed suggest that citizens were satisfied with the level of public services and often desired more but were simply unwilling to pay for them.*

Panel 1
Types and Classification of Tax and Expenditure Limitations

Overall Property Tax Rate Limitations: Limits on property tax rates are the most common form of TEL. If the limit is on overall property tax rates, a rate ceiling is set that cannot be exceeded without a vote of the electorate, and applies to the aggregate tax rate of all local government.

Non-binding: Easily circumvented through alterations in assessment practices.

Potentially Binding: If coupled with a limit on assessment increases.

Specific Property Tax Rate Limit: Same as for overall property tax rate limits except it applies to specific types of local jurisdictions (for example, school districts or counties) or narrowly defined service areas.

Non-binding: Can be circumvented through alterations in assessment practices or, in the case of specific services, through inter-fund transfers (fungibility).

Potentially Binding: If coupled with a limit on assessment increases.

Property Tax Levy Limit: This type of limitation constrains the total amount of revenue that can be raised from the property tax, independent of the property tax rate. It is often enacted as an allowable annual percentage increase in the levy.

Potentially Binding: The fixed nature of the revenue ceiling makes this, ceteris paribus, a more formidable constraint, however, it can be limited through a diversification of revenue sources (which is its underlying intent).

General Revenue or General Expenditure Increases: In the case of revenue limits, these cap the amount of revenue that can be collected, while expenditure limits attempt to constrain spending during the fiscal year. These are often indexed to the rate of inflation.

Potentially Binding: The fixed nature of the revenue or expenditure ceiling makes this, ceteris paribus, a more formidable constraint.

Limits on Assessment Increases: Since the property tax collected is a function of the assessed valuation of the property, and the tax rate, this type of limitation controls the ability of local governments to raise revenue by reassessment of property or through natural or administrative escalation of property values.

Non-binding: The constraint is easily avoided through an increase in property tax rates.

Potentially Binding: If coupled with an overall or specific property tax rate limit.

Full Disclosure - Truth in Taxation: These types of limitations generally require some type of public discussion and specific legislative vote prior to the enactment of tax rate or levy increases.

Non-binding: Requires only a formal vote (generally a simple majority) of the local legislative body to increase the tax rate or levy.

General Research on Tax and Expenditure Limitations (TELs) and the Structure of the State and Local Public Sector

Since the widely publicized "tax revolt" in California (Propositions 13 and 4), Massachusetts, New Jersey, and Michigan, investigation of tax and expenditure limitations has increased substantially. Much of this research can be divided into the following broad areas: 1) studies of the reasons for support of tax and spending limitations by voters (Ladd and Wilson, 1983; Courant, Gramlich and Rubinfeld, 1985; and Stein, Hamm and Freeman, 1983); 2) descriptions of specific limitations, or cross-sectional summaries of their characteristics and projected effects (Peterson, 1981; Ladd, 1978; Shapiro and Morgan, 1978; and Bails, 1982); and 3) empirical studies of the impact of TELs on state and local finance, including analyses of their impact on the size of the public sector in TEL states and, to a lesser degree, the distributional impact of TELs (Kemp, 1982; Danziger, 1980; Sherwood-Call, 1987;

Research Method

Testing these propositions involves a multi-step process. First, the changes in the structure of the state and local public sector between 1960 and 1988 will be described. This will include analyses of: 1) the "shifts" in distribution among various revenue and expenditure items (total taxes versus charges and miscellaneous revenue, for example) for state and local government; and 2) the changes in the state "share" of total state and local revenue and spending over time. Second, differences in revenue and expenditure ratios (shifts) and state shares within states will be analyzed relative to the existence of various kinds of tax and expenditure limitations. Financial data for revenues and expenditure categories were taken from published Census Bureau documents for the period 1960 through 1988. These data were primarily contained in the bureau's annual *Governmental Finances Documents* (U.S. Department of Commerce, 1961-1989). Analysis of trends in state revenue and expenditure structure will be subdivided according to the existence of three categories of limitation:

1. limitations on the ability of state government to raise revenue or spend money;
2. potentially binding limits on local revenue or spending, including property tax levy limits, general revenue limits, general expenditure limits, and assessment limits where there are also property tax rate limits (see Panel 1); and
3. both state limits and local binding limits existing in the same state.

Table 2
Average Structure of Revenues, 1960-1988 (Revenue Distribution, in Percent)

A. Aggregate State and Local

Year	Taxes	Charges/Misc.	Federal Aid
1960	67	15	17
1965	65	16	19
1970	63	19	19
1975	59	19	23
1980	56	21	23
1985	56	26	18
1987	56	26	18
Change (60-87)	-11	+11	+1

B. State Government

Year	Taxes	Charges/Misc.	Federal Aid
1965	59	12	28
1970	59	14	26
1975	56	14	28
1980	55	16	28
1985	56	19	24
1988	56	19	23
Change (65-88)	-3	+7	-5

C. Local Governments

Year	Taxes	Charges/Misc.	Federal Aid	State Aid
1965	51	17	3	30
1970	47	17	3	32
1975	41	17	9	33
1980	38	20	9	33
1985	38	24	6	32
1988	39	23	4	33
Change (65-88)	-12	+6	+1	+3

Source: Authors' calculations from U.S. Department of Commerce, Bureau of the Census, *Governmental Finance* (Series issues 1960-1988), (Washington, D.C.: U.S. Government Printing Office, 1961-1989).

Reid, 1988; Merriman, 1986; Megdal, 1986; Susskind and Horan, 1983; Cebula, 1986; Kenyon and Benker, 1984; Howard, 1989; Chernick and Reschovsky, 1982; and DeTray, 1981).[2] Overall, these studies find: an electorate satisfied with pre-limitation levels of public services; limited effects on aggregate spending and tax burdens; conflicting distributional effects; shifts away from broad based own source revenue instruments and toward narrower bases, state aid and state assumption; increases in the federated structure of state and local government; reduced abilities of states to play equalizing roles between local governments; worsened fiscal conditions for larger cities; and possible impacts on the choice available to citizens regarding service and tax packages between communities.

The empirical studies have two characteristics. First, they tend to focus on single cases (states) rather than evaluating TELs generally. Second, even those that are cross-sectional attempt to test a narrow hypothesis; they are interested in whether tax and expenditure limitations succeeded in making government smaller. They focus on whether the TEL served as a "real" constraint, usually by assessing whether government expenditure is a smaller share of GNP after the passage of the TEL.

While these studies have contributed to our understanding of the impacts and limitations of TELs, there is perhaps a more fundamental question that has been ignored. That question is: What have the effects been on the *structure* of the state and local public sector? From previous studies, we have seen that jurisdictions have responded to the constraints offered by TELs by raising alternative (unconstrained) sources of revenue and by looking to intergovernmental resources. This has important implications for the distribution of the burdens of financing the state and local public sector and for the loci of responsibility/authority for decisions regarding service provision. These impacts have not been studied on a multistate basis.

At least two questions relating to the structure of the state and local public sector need to be addressed. First, to what extent have states with tax and expenditure limitations experienced changes in the distribution of revenues away from broad-based taxes (property, sales and income taxes) and toward more narrowly defined sources, such as user fees, excise taxes and games of chance? Second, have states with tax and expenditure limitations experienced a shift in the locus of responsibility for expenditure functions? For example, have local governments in states with binding limitations on property tax revenues turned to state government for increased funding for education? To the extent that the existence of tax and expenditure limitations may have had the unintended consequence of changing the revenue structure or shifting functional responsibilities between levels of government, it is important that these effects are known. For example, increased reliance on user fees and other narrow revenue sources may have the effect of making the state and local revenue system more regressive. A movement toward state aid and away from local funding of public schools may have both equity (e.g., greater progressivity) and efficiency (e.g., reduced congruence with local preferences) implications.

Focusing on the narrow question of whether TELs have led to less government, ignoring the kind of government that they leave us with, misses a potentially very important impact. Even if the preponderance of the evidence is correct, and tax and expenditure limits have *not* made the state and local sector into a smaller part of the economy, there may have been very important structural effects associated with changes in revenue sources or functional responsibility. It is to these changes that we direct attention here.

Questions/Propositions

Did the wave of tax and expenditure limitations that rolled over state and local government in the 1970s and 1980s leave the state and local public sector with a fundamentally different kind of structure than it had previously? This question is investigated using data gathered on state and local finance over the past 29 years. In doing so, three general propositions will be tested:

Proposition 1. The tax and expenditure movement has resulted in a revenue structure at the state and local level that is dominated to a greater extent by narrow sources (such as charges and miscellaneous revenue) than by traditional, broad-based taxes (such as income, sales and property taxes).

Proposition 2. Those states in which limitations are present at the local level rely more heavily on state aid to finance local services now than prior to the limitation movement, but this trend is moderated somewhat by the presence of limitations on state government revenues and expenditures.

Proposition 3. Local TELs have resulted in a general shift in functional responsibilities from local government to state government, while state TELs have had the opposite affect. The local expenditure shift has been more pronounced in those states that do not have separate limitations on state government.

Table 3
Average Structure of State and Local Expenditures (Percent)

A. Ratio of State Functional Expenditure to Total State General Expenditure

Year	Education	Health/Hosp.	Highways	Welfare
1965	24	9	34	12
1970	30	9	25	15
1975	28	10	19	19
1980	27	11	17	22
1985	25	10	15	21
1988	25	11	14	22
Ch. (65-88)	+1	+2	-20	+10

B. Ratio of Local Functional Expenditure to Total Local General Expenditure

Year	Education	Health/Hosp.	Highways	Welfare
1965	51	5	14	4
1970	52	5	8	4
1975	49	6	7	3
1980	47	7	7	2
1985	47	7	6	2
1988	46	7	6	2
Ch. (65-88)	-5	+2	-8	-2

C. State Share of Functional Expenditure as a Percentage of State/Local Functional General Expenditure

Year	Total	Capital	Education	Health/ Hosp.	Highways	Welfare
1965	43	58	26	59	72	67
1970	45	55	32	59	71	74
1975	45	48	31	59	67	84
1980	44	48	31	58	65	89
1985	46	50	32	57	65	89
1988	45	50	31	57	64	89
Ch.	+2	-8	+5	-2	-8	+22

Source: Authors' calculations from U.S. Department of Commerce, Bureau of the Census, *Governmental Finances* (Series issues 1960-1988), (Washington, D.C.: U.S. Government Printing Office, 1961-1989).

Comparative Results

In describing the changes in the state and local public sector over the past 29 years, two broad categories of data will be presented. First, aggregate figures will be used to describe the state and local revenue structure, in total, and then by the level of government (state versus local). Second, trends in state and local finance are graphed and analyzed relative to the existence of these various types of limitations.

Average Revenue Structure

Table 2 summarizes the average revenue structure of state and local government between 1960 and 1987, and subdivides this analysis by the state and local components of this sector. The figures present the average distribution of revenues and expenditures among the states. That is, given that the state and local public sector within individual states are our units of analysis (rather than population or aggregate expenditure levels), proportions are calculated for each state individually and then averaged across the 50 states.

The state and local aggregate data suggest a sharp shift in the sources of revenue over the period, with a movement away from general taxes toward charges and miscellaneous revenue. When these data are disaggregated into their state and local sectoral components, some additional trends are apparent. While the general trend toward increasing charges and miscellaneous revenue is both a state and local phenomenon, state governments have also experienced a loss in federal aid that has exceeded their loss in tax revenue. Local governments, in contrast, have experienced increases in the state and federal portion of total general revenue, while sharply decreasing local taxes.

Average Expenditure Structure

Changes are also apparent on the spending side. Table 3 presents aggregate data on average ratios of individual state and local functional expenditure items as a portion of total expenditure for that level (state or local) of government. In addition, Table 3 presents the average state share of total state and local expenditures over time. The table indicates that, as a component of total state spending, state education and health/hospital spending have experienced a slight relative increase over time, while highway spending has declined dramatically, and public welfare spending has experienced a large relative increase. For local governments, the shifts have been toward health and hospital spending and away from education, highway and public welfare spending.

The state share of state and local general expenditure (part C of Table 3), shows the change in state versus local responsibility for expenditures over time. This share of total spending has increased slightly overall. However, these aggregate trends mask more pronounced changes in specific functional categories. State spending on education and public welfare has increased significantly over the 23 year period, while expenditures for capital outlays, health and hospital spending, and highway spending has declined over time.

While these general trends are informative, what remains to be seen is whether changes in the structure of the state and local sector are more marked in states with TELs. One mechanism for answering this question is to compare states with state limitations, those with binding local limitations, and those with both state and local limitations to the experience of the state and local sector as a whole to assess the extent to which trends differ. In the remainder of this section, summary data are graphically presented to investigate the structural revenue and expenditure changes in states with various kinds of TELs. States are subdivided according to the existence of three kinds of TELs: 1) limitations on state government; 2) potentially binding local limitations (as defined in Panel 1); and 3) state government limitations coupled with potentially binding local limits. In Panel 2, states falling within each of these three categories are listed. As the panel indicates, during the period covered by this research, there were 20 states with state limitations, 28 states with local binding limitations, and 14 states with a combination of the two.

In the following graphs, data are presented on states with these various types of limitations, using five year moving averages. We refer to these presentations as "difference series" because they show the difference in structure between TEL states and the average for all states over time. The important consideration here is the extent to which TEL states deviate from the national average revenue and expenditure trends. Each graph includes a zero reference line which corresponds to the national average for all states. The plots for the states with limitations reflect variations ("differences") from the average national trend. Two vertical lines appear on each graph identifying the period of increased local TEL activity (1970-1978) and the period of increased state TEL activity (1978-1986).[3]

Presence of State Limitations

First, data will be presented that evaluate the impact on the state and local sector of the presence of state government limitations. We would expect that the presence of limitations would have the effect of decreasing state assistance to local governments, while possibly increasing the level of local taxation. In addition, the state share of revenue and taxes should decline, as should the state share of expenditures. Figures 1a through 1c present trends representing the deviation of states with *state government limitations* (STELs) from the national average in several revenue and expenditure categories.

Figure 1a shows trends (shifts) for states with STELs in four areas: 1) state taxes as a percent of total state general

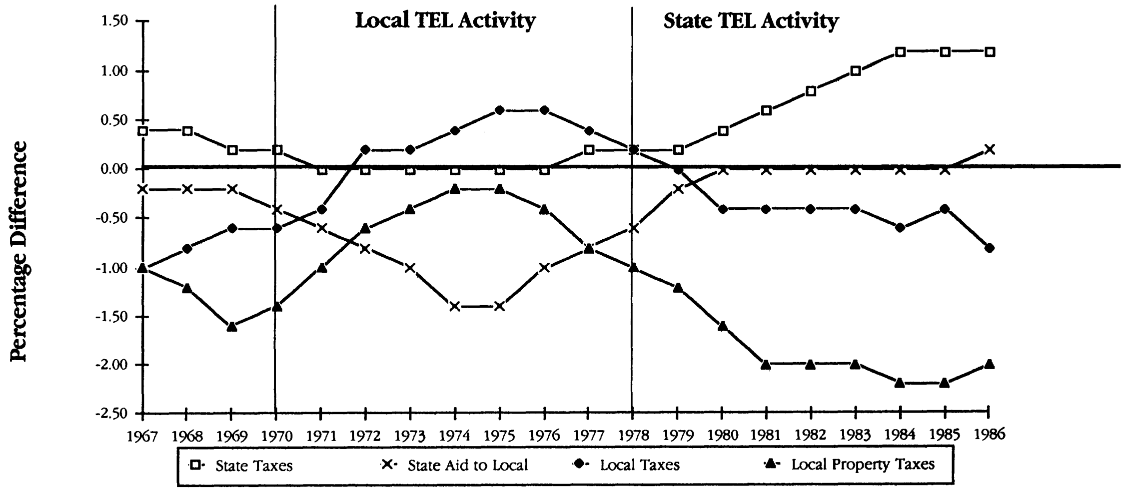
Panel 2
State and Local Tax and Expenditure Limits

State	Non-Binding Local Limit[a]	Potentially Binding Local Limit	State Limit	State limit and Potentially Binding Local Limit
Alaska	X	X	X	X
Alabama	X			
Arkansas	X	X		
Arizona	X	X	X	X
California		X	X	X
Colorado	X	X	X	X
Connecticut				
Delaware	X	X	b	
Florida	X			
Georgia	X			
Hawaii	X			
Iowa	X	X		
Idaho	X	X	X	X
Illinois	X	X		
Indiana		X		
Kansas		X		
Kentucky	X	X		
Louisiana	X	X	X	X
Massachusetts		X	X	X
Maryland	X	X		
Maine				
Michigan	X	X	X	X
Minnesota	X	X		
Missouri	X	X	X	X
Mississippi	X	X		
Montana	X		X	
North Carolina	X			
North Dakota		X		
Nebraska	X			
New Hampshire				
New Jersey		X	X[c]	X
New Mexico		X		
Nevada	X	X	X	X
New York		X		
Ohio	X	X		
Oklahoma	X		X	
Oregon	X	X	X	X
Pennsylvania	X			
Rhode Island	X	X	X	X
South Carolina			X	
South Dakota	X			
Tennessee	X		X	
Texas	X		X	
Utah	X		X	
Virginia	X			
Vermont				
Washington	X	X	X	X
Wisconsin	X			
West Virginia	X			
Wyoming	X			

Notes: See end of article.

Sources: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism: 1987 Edition,* M-151 (Washington, DC: U.S. Government Printing Office, 1987), pp. 116-117; and National Conference of State Legislatures (NCSL), *Legislative Budget Procedures in the 50 States: A Guide to Appropriations and Budget Processes* (Denver, CO: NCSL, September 1988), Table IV-1. Classification of local limits as non-binding or potentially binding is the authors'.

Figure 1a
Difference Series: Revenue Proportions Under State Limitations



revenue; 2) state aid to local governments as a percent of local general revenue; 3) local taxes as a percent of local general revenue; and 4) local property taxes as a percent of total local general revenue. This graph can be interpreted as follows. For example, the line representing state taxes (which has a value of 0.4 in 1967, decreases to 0 in the period from 1971 to 1976, and increases to 1.2 by 1984) shows that, in those states with state limitations, the proportion of state taxes to total state revenue was 0.4 percentage points higher than the national average in 1967, but decreased to the average of all states by 1970 to 1976. By 1984, however, state taxes as a percentage of total state revenue were 1.2 percentage points higher in states with limitations. The graph also indicates that, while experiencing relative growth in the late 1960s through early 1970s, beginning in the late 1970s, local taxes (along with local property taxes) decreased as a percentage of total local revenues. At the same time, state aid to local governments increased markedly.

Figures 1b and 1c depict specific revenue and expenditure items as a percentage of total revenues or expenditures of state and local governments within states with STELs compared to the average of all states. Specifically, Figure 1b deals with revenues (total general revenue, total taxes, property taxes, and sales taxes). Figure 1c shows expenditures (total expenditures, capital expenditures, educational expenditures, highway expenditures and public welfare expenditures). The state government share of total state/local revenue (Figure 1b) declined in those states with state TELs. However, while

Figure 1b
Difference Series: State Share of General Revenue Under State Limitations

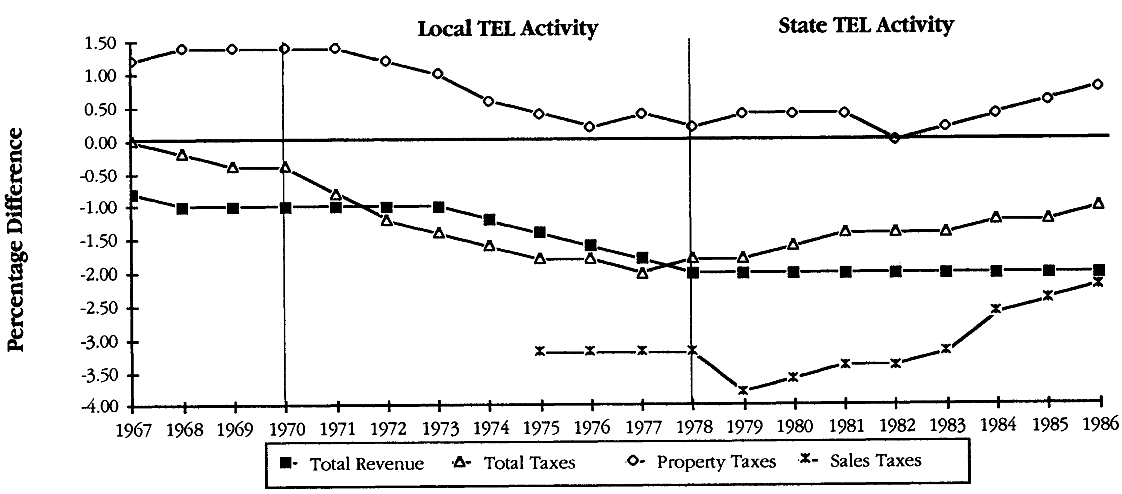
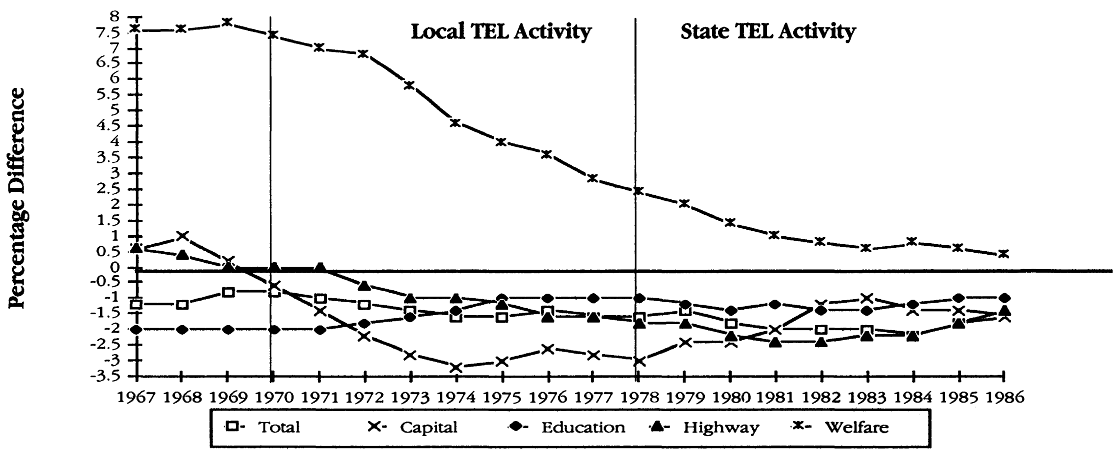


Figure 1c
Difference Series: State Share of General Expenditure Under State Limitations



showing a similar pattern prior to 1977, the state share of taxes rose slightly after 1978. The state share of property and sales taxes declined until the late 1970s, and then rose slightly. Figure 1c shows that states with limitations exhibit mixed results with respect to direct expenditures. The state share of total expenditures declined slightly, fueled by a substantial reduction in the state share of public welfare expenditures. While the patterns are inconsistent, the state spending share also declined slightly for capital and highways. The state share of education spending, on the other hand, increased very slightly relative to the average for all states.

Presence of Potentially Binding Local Limitations

The existence of local binding limitations would be expected to result in decreased local taxes, increased state aid, and increases in the state's share of revenue and spending. Figures 2a through 2c present trends on the differences between the average state/local composition for those states with *local, potentially binding limitations* (LTELs) compared to the national average for all states. The areas of comparison again include the ratio of various revenue items to total revenue, the state's share of revenue, and the state's share of expenditure.

Figure 2a shows that states with local binding limitations were those with lower than average local taxes (particularly after 1976) and higher than average state aid receipts. While local taxes (including property taxes) as a component of total local revenues declined throughout the period, state aid increased sharply. State taxes as a component of total state

Figure 2a
Difference Series: Revenue Proportions Under Local Binding Limitations

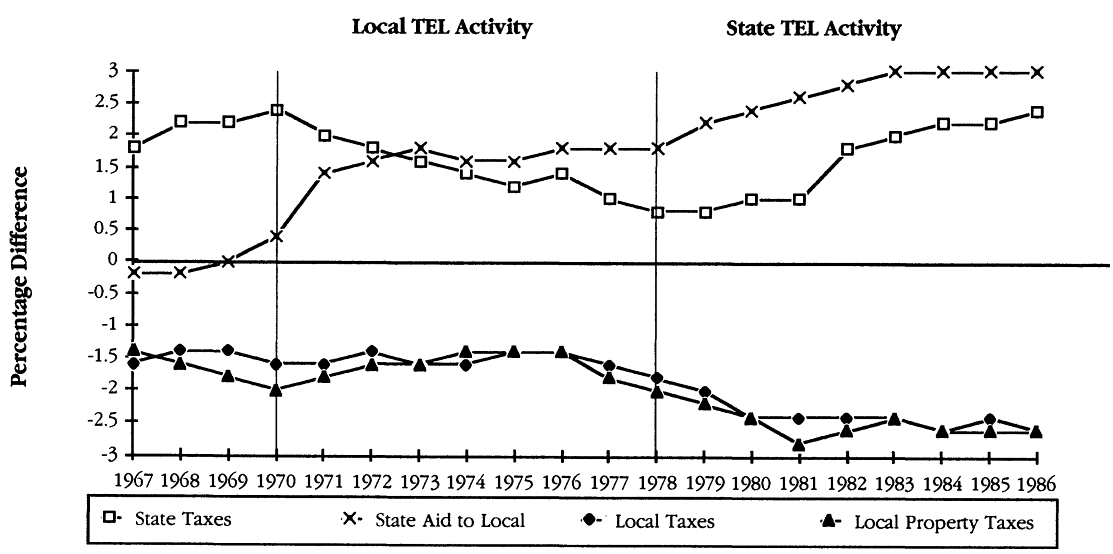
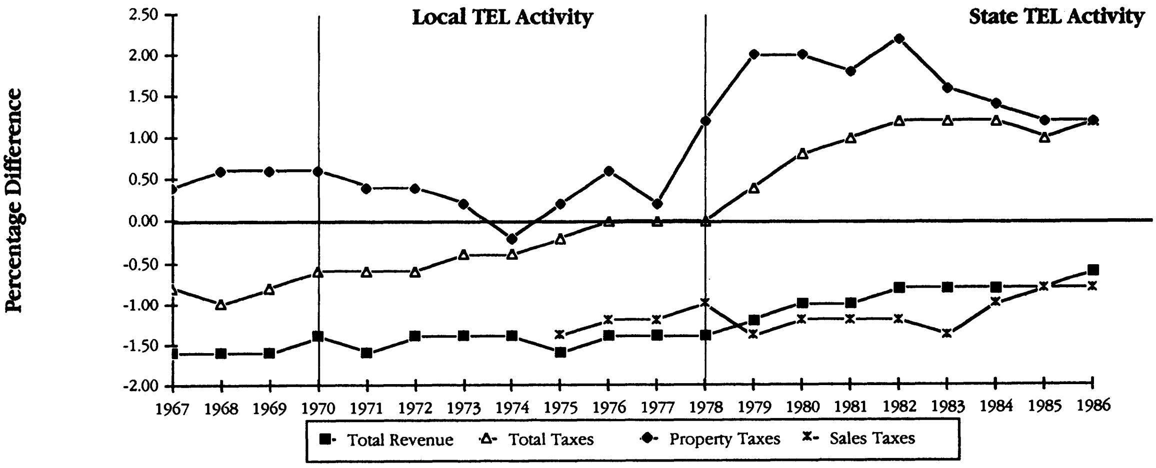


Figure 2b
Difference Series: State Share of General Revenue Under Local Binding Limitations



revenues declined until the late 1970s, when they began to rise steadily.

Figure 2b indicates that the state share of revenue increased in states with local binding limitations as well. Specifically, this figure shows the state share of total state and local revenues in the following categories: 1) total general revenue; 2) total taxes; 3) property taxes; and 4) sales taxes. The state share of total general revenue and sales tax revenue increased only slightly over the period. However, the state share of total taxes rose sharply after 1970, and the state share of property taxes increased markedly after 1976 (indicating, of course, the decline in local property taxes). It is also interesting that the total local burden started out greater for these states than for the nation as a whole and continued so throughout the period. In 1976, however, the local burden associated with taxes in LTEL states became equal to the national average and declined over the remainder of the period.

Figure 2c displays trends for the state share of total state/local expenditures for states with LTELs. What is most striking about this graph is that, in all expenditure categories, the state share in states with LTELs was less than the national average (or, alternatively, the local burden was consistently greater); however the state share grew steadily and substantially after the early 1970s. The state share of total expenditure and capital spending rose sharply over most of this period, particularly after 1972. Education and welfare spending increased after 1973, and then leveled off around 1977. The state share of highway expenditures appears relatively unaffected by the presence of local binding limitations.

Presence of Both State and Local Binding Limitations

The impact of the simultaneous presence of state and local binding limitations on the structure of state and local government is hard to predict. Since both levels are constrained, we might expect to find few shifts between the state and local

Figure 2c
Difference Series: State Share of General Expenditure Under Local Binding Limitations

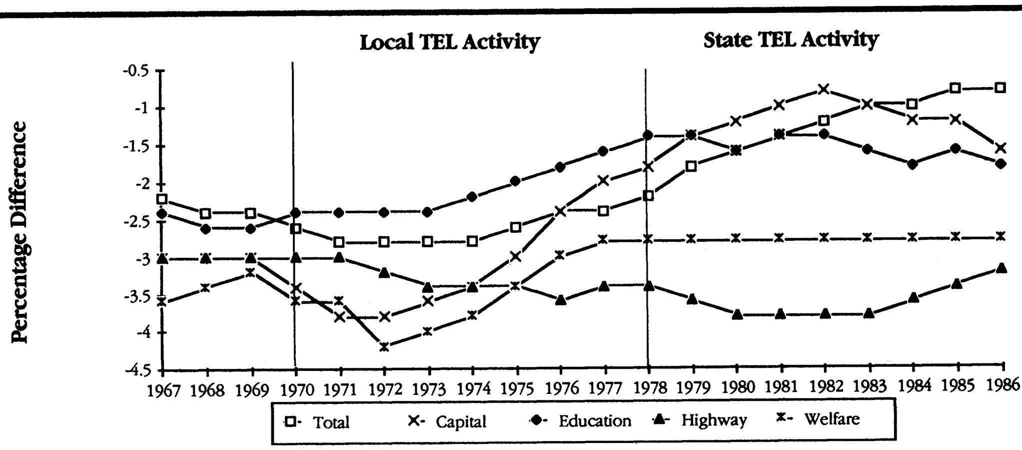
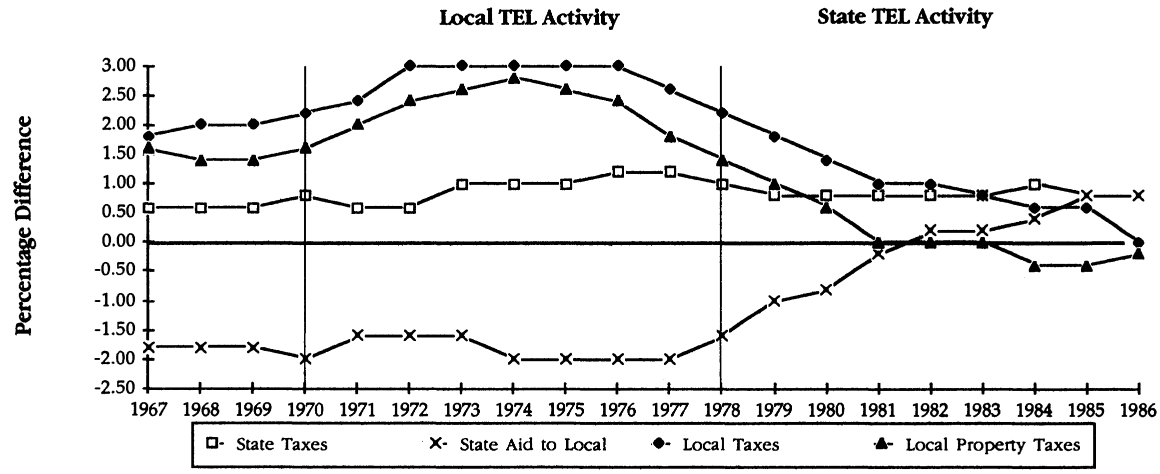


Figure 3a
Difference Series: Revenue Proportions Under State and Local Binding Limitations



sector in either revenue or expenditures. At the same time, state governments have greater flexibility in responding to limitations than do local governments, suggesting that we might see some movement toward greater state financing in these states. It seems unlikely that we would see an increase in local activity, as local activity has already been shown to be high in LTEL states. Figures 3a through 3c show the comparison of revenue and expenditure structure in those states with *both STELs and LTELs* to that of the national average for all states.

Figure 3a shows the proportions of revenues coming from various sources for state and local governments with both STELs and LTELs. Revenue categories include: 1) state taxes as a percent of total state general revenue; 2) local taxes as a percent of local general revenue; 3) state aid to local governments as a percent of local general revenue; and 4) local property taxes as a percent of total local general revenue. In states with both state and local binding limitations, state aid to local governments increased sharply after 1977. At the same time, local taxes (including property taxes) began declining sharply. State taxes remained relatively constant as a component of state general revenue throughout the period. States with state and local binding limitations had proportionately higher than average taxes throughout the period, higher than average local property taxes until 1983, and lower than average state aid prior to 1984.

Figure 3b again shows the relative state share of total state and local general revenue for states with both STELs and LTELs. It indicates a sharply increasing share of taxes for state governments after 1977 and a decreasing share of sales

Figure 3b
Difference Series: State Share of General Revenue Under State and Local Binding Limitations

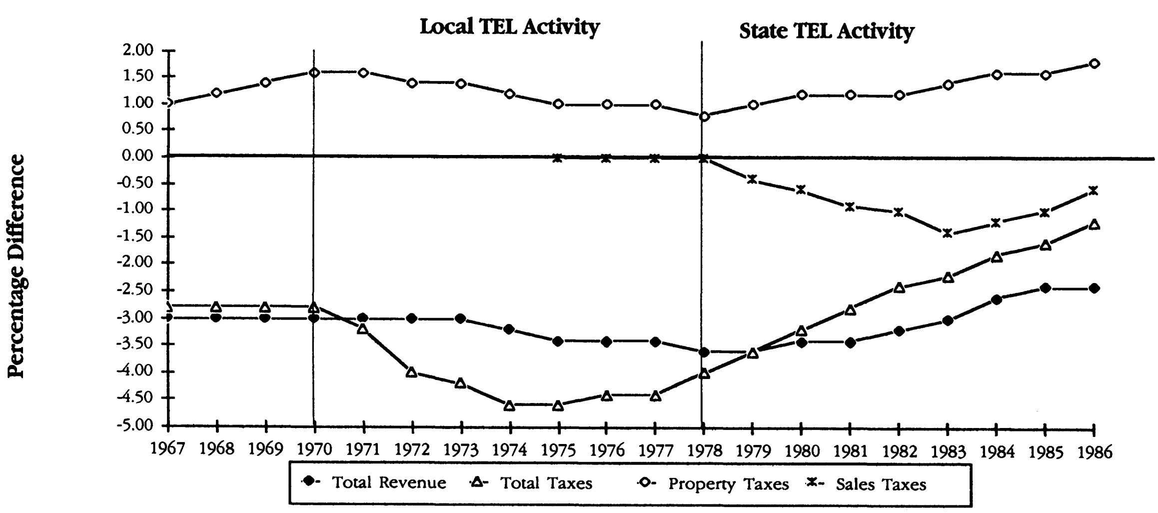
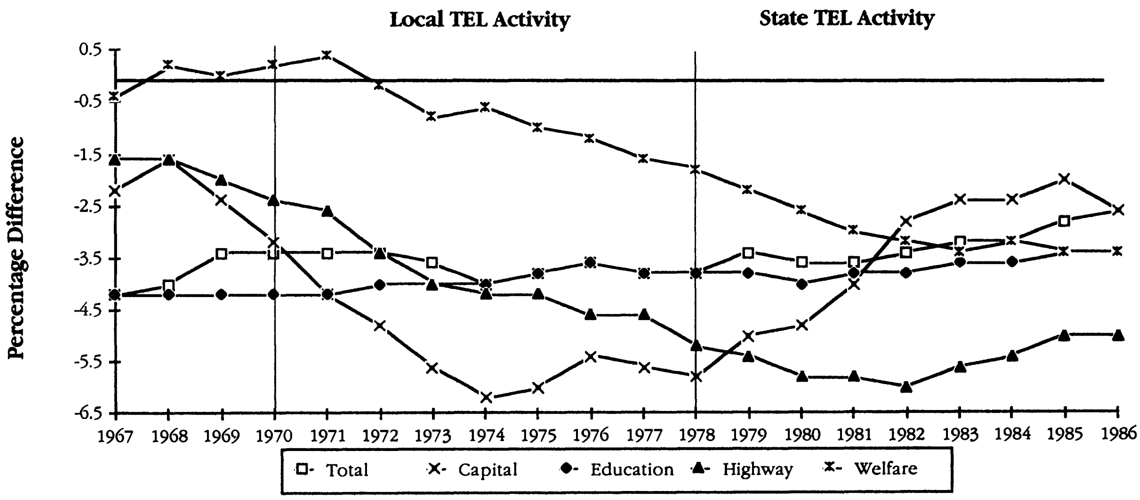


Figure 3c
Difference Series: State Share of General Expenditure Under State and Local Binding Limitations



tax revenue after 1980. States with both state and local limitations showed less dramatic shifts in the state share of property taxes and total revenue, with the relative state share of each increasing over time.

With respect to the state average share of expenditures (Figure 3c), states with both state and local binding limitations once again show a state share which was less than average. There are, however, variations in trends over time. The state share of total general expenditures and education expenditures, while relatively constant, showed a slight increase over time. Capital spending, however, sharply increased after 1974. Welfare and highway spending declined rather steadily throughout virtually the entire period.

Discussion

Our propositions had suggested three things. First, that the state and local level is dominated to a greater extent by narrow sources of revenue as a result of the tax and expenditure limitation movement. Second, that local limitations promote state assistance to offset the impact of decreasing local taxes, but that this is moderated in those states that have state government limitations. Third, that the TEL movement has resulted in the shifting of responsibility for certain expenditure functions to state government from local government, a trend that is more pronounced in the absence of state limitations.

The analysis presented above has addressed each of these questions directly by comparing the revenue and expenditure structure in those states with limitations to the average state and local structure for the nation. Below we consider the implications of the analysis for each of the three propositions.

Impact of TELs on Level and Share of Taxes

Contrary to our expectations, state limitations seem to have had no effect on the level or share of state taxes; state taxes increased as a source of revenue in limitation states, implying movement away from other sources of revenue such as charges and fees. On the other hand, in states with state limitations, local taxes decreased more than in the average state and state aid climbed. Alternatively, while the shift was very slight, the state *share* of total state/local revenue has declined slightly over time in these states. While this result is somewhat puzzling, it is clear that, in states with state government TELs, we can see little evidence to support the suggestion of a shift away from broad based taxes and toward a reduced state role in the total state/local public sector.

Local limitations, however, demonstrated precisely the effect that we expected. In states with local limitations, state taxes declined steadily through the mid 1970s, but have increased steadily since then. Local taxes, in contrast, declined throughout the entire period, implying a greater reliance on fees and charges (and, as discussed below, increased state aid to localities). This trend, however, has *not* been more pronounced since the local limitation movement reached the height of activity in the late 1970s. The state share of taxes in these states increased steadily, while the share of total revenue remained relatively constant, implying that local governments are making up the difference through other sources.

Finally, states that have both state and local limitations showed relatively constant state taxes but a declining level of local taxes. This suggests that ***the limitations seem to have been more binding on the local than on the state governments.*** Overall, the state share of revenue in these states remained relatively constant as well, while the state share of taxes increased. This increase in state taxes corresponds roughly to the timing of the "movement" and, given the relatively constant trend in total revenue also suggest greater local reliance on other sources.

The conclusion that we can draw relative to the stated proposition is that, if there is any effect of LTELs, that effect is on the level of local taxes. State taxes do not seem to be affected by any kind of limitation, although the possibility of an effect may be lessened by the necessity to "bail out" local governments. In each of the three cases, state taxes actually increased to a greater extent in states with state or local limitations, although the least substantial increase was where there were both state and local limitations.

State Aid to Local Governments

State aid to local governments showed an overall increase in states possessing state limitations. While initially declining, this increase has occurred since the mid 1970s, reversing the previous five-year trend. This is a somewhat unexpected result in states that have state government limitations, particularly given that the first modern state limitation was enacted in 1976.

In states with local binding limitations, the trend was also toward increased state aid, as expected. This is opposite the trend toward declining local taxes. Interestingly, though, the increasing state aid and the decreasing local taxes were both steady trends throughout the entire period, without clear correspondence to the timing of local TEL activity.

In cases where there are both state and local limitations, the situation reflects a combination of the trends in the previous cases, although its level is more similar to the state limitation case. Relatively constant during the previous period, there was a discernible increase in the level of state aid to local governments beginning in the mid 1970s, at the same time that local taxes began to decrease.

In short, in all three cases there was an inverse relationship between local taxes and state aid. However, there are two separate situations represented. Where there are either state limitations or limitations on both levels of government, the increase in state aid seemed to follow the increased level of TEL activity. Under purely local binding limitations, state aid appears to follow a pre-limitation trend.

Functional Expenditure Shifts

Under state limitations, the only functional category for which there was a shift toward local government provision is public welfare. The trend was continuous and did not become more pronounced during the height of the TEL movement. Given that welfare responsibility has traditionally been centered more heavily within these states and the trend toward greater reliance nationwide on states for welfare expenditures (Table 3), this suggests that states without limitations have caught up in relative responsibility for welfare. Total spending in other functional categories remained a relatively constant share.

[T]he limitations seem to have been more binding on the local than on the state governments.

The functional effects of local expenditure limitations generally appeared as expected. The state share increased in all categories except highways. Even more interesting, the trends for total general expenditures, education expenditures, public welfare expenditures and capital expenditures appeared to follow a time pattern consistent with the enactment of limitations. The state share of expenditures in these categories increased much more sharply after the early to mid 1970s. Given that for all categories the state share remains less than the national average, local TELS may have stimulated a movement away from what might have been considered an excessive local burden for expenditures.

Finally, where both state and local limits are present, the states have been less inclined to assume greater relative responsibility. The state share of total spending and education spending remained relatively constant. State welfare spending and highway spending declined steadily while capital spending, declining in earlier periods, increased sharply after the late 1970s. This time period corresponds with the enactment of state and local limitations.

To summarize, the trends are toward the expected shifts in the case of local binding limitations, but in cases of state limitations and state/local limitations (with the exception of capital expenditures), already existing trends appear to continue.

Do Limits Make a Difference?

The question that we asked at the outset of this research remains somewhat of a quandary. That is, we have demonstrated that there are significant differences over time in revenue and expenditure structure between those states in which there are limitations and the average state. It is not entirely clear, however, whether these are the continuation of trends existing before the enactment of a particular TEL or whether the TEL itself made a difference. As noted above, in some cases the trends uncovered show marked differences after the period of greatest TEL activity. In other cases there is no substantial change in the trends after this period. Also, limitations on state governments appear to be less important, most likely attributable to their non-binding nature and the wide array of methods available to the states to circumvent them.

This suggests two competing conclusions about the impact of tax and expenditure limitations. First, that the imposition of the TEL itself has effects that have resulted in an altered revenue and expenditure structure in those states which have enacted local TELs, and that those changes can be traced to the point at which the TEL was enacted.

Alternatively, there may be some other difference between states enacting TELs and those that have not. That is, that there may be a particular "mood" about taxation in these states that operates relatively independently of the legal limitation. The limitation itself, while tangible evidence of that mood, is not the controlling event. Rather, the revenue and expenditure structure in these states was already shifting and simply continued to do so after the enactment of the limitation. There may, in addition, be particular historical, structural or political differences between TEL and non-TEL states that account for these findings.

These are testable hypotheses. What remains to be seen is which of the two, if either, represents the "real" explanation for what it is that makes the states that enact TELs differ from those that do not. We have demonstrated here that there have been significant shifts in revenue and expenditure structure. Precisely how the shift may be causally related to the implementation of tax and expenditure limitations is fertile ground for future inquiry.

In further considering the effect of TELs, two points should be made. First, the strongest indications are that local TELs have resulted in movement away from local taxes toward alternative revenue sources and state aid, and toward a greater expenditure role for states. In some ways the revenue effects are offsetting. While a movement toward fees and charges associated with TELs is generally considered to do violence to the progressivity of the state and local revenue generation system, movement toward state aid (due to the greater progressivity of state tax structures) is expected to *increase* the progressivity of this system. The combined result of these shifts is an important and yet unanswered policy question.

Second, the expenditure effects are also important. It appears that the local TEL effect has not been limited to a shift in the source of financing. An increase in the level of direct expenditures made by state governments increases the distance between the locus of responsibility and authority for delivering public services and the population to be served. This, according to the public choice model, tends to reduce the efficiency of government (i.e., its ability to function in a way consistent with local preferences).

Given that proponents of the tax limitation cause have often come from the ranks of public choice advocates, this result is surprising. In order to determine the degree of this inconsistency, a more detailed look at the functional areas affected, and the local structure established to deliver local services, is warranted. Another point of interest concerns the differing effects of increased state aid and increased local fees and charges. If increased fees and charges are more consistent with the costs of providing local services, the end result advances allocative efficiency from the public choice perspective. However, unless state aid is tied directly to those services with a higher redistributive component, its increase may impede achievement of this same notion of efficiency. A second set of questions, then, revolves around whether fees have been raised in a manner consistent with costs and exactly how state aid is being distributed.

From the data presented here, it seems clear that TELs at the local level (or at least the public attitudes surrounding them) have made a difference. Further, they have made a difference in ways that are vitally important to our system of state and local governance. Further research should explore these effects more comprehensively, systematically and definitively, focusing on the above questions and others. A particularly interesting area of inquiry (one alluded to but not directly addressed in this analysis) concerns the effect of TELs on the horizontal structure of local governance. That is, have TELs had consequences for the locus of authority and responsibility between units at the local level? The anecdotal evidence suggests that they may have. How does this affect local governance? These are questions that remain to be answered.

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Notes from Panel 2

a. Because of the variety of local limits possible, some states have placed both non-binding and potentially binding limitations on their local governments. For example, a state which requires full disclosure (non-binding) and has enacted a property tax levy limit (binding) has both binding and non-binding forms of local limits. For purposes of the analysis presented here, we are concerned with only local limits which are potentially binding. We have, however, included non-binding limits in the table in order to provide the reader a thorough summary of TELs.

b. Delaware's State limit limits the budget year's appropriations to 98 percent of the amount of estimated general revenue plus the prior year's unencumbered funds. It is akin to a balanced budget requirement rather than a limitation and therefore is not included as a state limitation in this analysis

c. New Jersey's State limitation expired in 1983. It is included in this analysis.

Notes

1. Of course other taxes, beginning for the United States with the Stamp Act in 1765, have caught the attention of the public. In recent surveys conducted annually by the Advisory Commission on Intergovernmental Relations, however, the property tax consistently ranks among the "worst,...least fair" taxes. It holds this distinction jointly with the federal income tax. During the 1970s the property tax generally won-out over the income tax as the "worst" tax followed by a period from 1979 to 1988 when the income tax held this distinction. In 1989, however, the property tax regained this title (ACIR, 1989).
2. Research on voter support for TELs finds the electorate voicing a desire for lower taxes and more efficiency in government, but not a cut back on public services (Ladd and Wilson, 1981; Ladd and Wilson, 1982; Ladd and Wilson, 1983; Courant, Gramlick and Rubinfeld, 1985). Others have found that voters support TELs in line with their self-interest; those whose tax burdens would be most clearly affected support the limitations (Stein, Hamm and Freeman, 1983).

   Other research has focused on describing and projecting the impacts of TELs on spending (Ladd, 1978; and Bails, 1982), intragovernmental and intergovernmental finance structure (Shapiro and Morgan, 1978), and local fiscal condition (Peterson, 1981).

   Empirical studies of the actual (as opposed to hypothetical) impact of TELs on the state and local sector focus on tax burdens, and broader effects in single and multiple jurisdictions. Research on tax burdens explores 1) the aggregate burden and 2) the distribution of this burden (Chernick and Reschovisky, 1982; DeTray, 1981).

   Other empirical studies review the impact of TELs on state and local finances in specific states, concentrating on California (Kemp, 1982; Danziger, 1980; Sherwood-Call, 1987 and Reid, 1988), New Jersey (Merriman, 1986; Megdal, 1986) and Massachusetts (Susskind and Horan, 1983). A limited number of studies assess the impact of the enactment of a hypothetical TEL across states (Cebula, 1986) and others assess aggregate spending and fiscal policies across states (Kenyon and Benker, 1984; Howard, 1989).
3. To provide a common base of reference for each graph, moderate the effect of extreme cases and for conceptual clarity, all comparisons are between the average experience within limitation states as a group and the national average for states.