FISCAL CONTAINMENT: WHO GAINS? WHO LOSES?

PREPARED UNDER A GRANT FROM THE FORD FOUNDATION

ANTHONY H. PASCAL & MARK DAVID MENCHIK

R-2494/1-FF/RC

SEPTEMBER 1979

Adapted from R-2494-FF/RC, *Fiscal Containment of Local and State Government*, by Anthony H. Pascal, Mark David Menchik, Jan M. Chaiken, Phyllis L. Ellickson, Warren E. Walker, Dennis N. De Tray, and Arthur E. Wise, September 1979.

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PREFACE

This Rand report is a summary adaptation of R-2494-FF/RC, *Fiscal Containment of Local and State Government*, by Anthony H. Pascal, Mark David Menchik, Jan M. Chaiken, Phyllis L. Ellickson, Warren E. Walker, Dennis N. De Tray, and Arthur E. Wise, September 1979. Except for Fig. 4, data in all tables and figures herein are drawn from R-2494-FF/RC. The research was sponsored by The Ford Foundation, with additional support from Rand corporate funds. Three other Rand publications are of related interest:

- *Growth in Municipal Expenditures: A Case Study of Los Angeles*, by Jan M. Chaiken and Warren E. Walker, N-1200-RC, June 1979. This Rand-sponsored note examines spending patterns in the City of Los Angeles prior to the passage of Proposition 13. Its findings are summarized in this report and, in more detail, in R-2494-FF/RC.
- *The Fiscal Limitation Movement: Present Context and Outlook*, by Phyllis Ellickson, N-1160-FF, May 1979. Sponsored by the Ford Foundation, this note describes current approaches to subnational fiscal limitation. Its findings are also summarized in this report and in R-2494-FF/RC.
- *Political and Legal Responses to Proposition 13 in California*, by Albert J. Lipson with Marvin M. Lavin, R-2483-DOJ (forthcoming), is sponsored by the National Institute of Law Enforcement and Criminal Justice and by Rand. The report traces the development of state legislation that implemented Proposition 13 and cushioned its first-year impact on local government.

Our research would not have been possible without the support and encouragement of James Kelly, of The Ford Foundation, and David Lyon, of The Rand Corporation. We also gratefully acknowledge the assistance of Rand colleagues Sue Berryman, Brent Bradley, Richard Buddin, Michael Caggiano, Stephen Carroll, Millicent Cox, Nicelma King, Albert Lipson, Lorraine McDonnell, Wayne Perry, and Joanne Wuchitech, and of John Kirlin of the University of Southern California.

INTRODUCTION

An era of fiscal containment is upon us. Taxpayers' complaints have always been part of the American scene, and a disenchantment with government seems to pervade the general public. These attitudes of the public and its elected representatives have fused in the last few years into a genuine "tax revolt," the enactment of state-level fiscal limits, and attempts to control the federal budget. Half of the 50 states now impose some sort of limitation on local taxes or on state revenues and expenditures; 16 of them have adopted some form of control since 1975 alone. Together, these forces promise to contain the growth of government in the United States. One result has been that, since 1975, the fraction of the Gross National Product (GNP) accounted for by government has fallen for the first time in fifty years.

This report outlines the recent course of events in government spending, taxation, and employment at all three levels, and briefly reviews the fiscal limitation movement and its accomplishments. The report also includes the findings from a case study of the recent fiscal history of Los Angeles, which may help explain taxpayer discontent.

Prevailing sentiment, as expressed through the American political system, appears to favor containment, if not contraction, in government. Along the road to this objective, some groups are likely to suffer as others gain. The report concludes with an assessment of the social costs and political effects that containment may engender. It is offered in the hope that, armed with foreknowledge, the nation can avoid causing needless harm through unreflective zeal.

TRENDS IN LOCAL AND STATE FINANCE

Spending

There is accumulating evidence that growth in government spending is slowing to a halt. Table 1 traces the trends in spending by level of government from 1929 to the present. Over the last four years, the average rate of annual increase for the three levels of government combined has been half what it was between 1949 and 1975. The rate has shrunk the most for local and federal spending; only state spending even approaches its historical rates, and we argue below that it, too, may slow down further before long. State and local spending exceeded federal spending before World War II, but fell far below it in the postwar years (see Fig. 1). Since 1969, however, the state share has crept up 3 percentage points while the federal share has dropped by the same amount.

The historic growth in the federal share of public spending has reversed, while the local share has leveled off

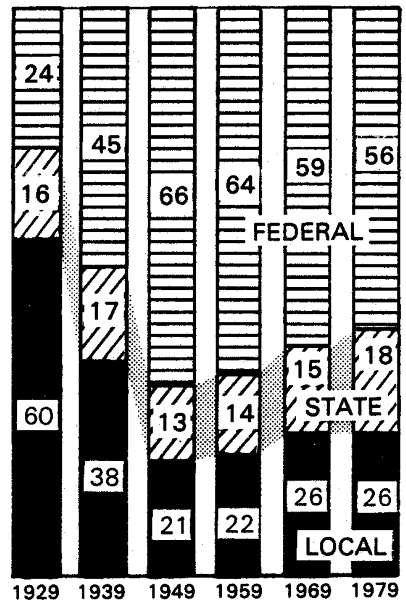

Fig. 1—Shares of total government spending by level, 1929-1979

Spending continues to increase at all levels but, in recent years, at a declining rate

Table 1

STATE, LOCAL, AND FEDERAL SPENDING, 1929-1979
(In $ billion 1967)

Year	Local	State	Federal	All Levels
		Expenditures		
1929	11	4	4	19
1939	20	7	18	45
1949	18	12	53	83
1959	33	21	96	150
1969	68	39	153	260
1975	86	56	189	331
1979[a]	95	66	203	364
		Average Annual Rate of Change (%)		
1929-1975	4.6	5.9	8.7	6.4
1949-1975	6.2	6.1	5.0	5.5
1975-1979	2.3	4.1	1.8	2.4

[a]Estimated.

A similar pattern is visible on a per capita basis, as shown in Fig. 2. For all three levels, annual spending per person has grown steadily since 1929, from under $100 (inflation-adjusted) to over $900 for the federal government and to over $400 for local governments. But in the last four years, as Fig. 3 indicates, the fraction of GNP accounted for by government spending has begun to fall off, notably at the federal level.

Government Employment

Government employment has risen roughly in parallel with spending, since wages and salaries account for about four-fifths of total spending. Table 2 again indicates the moderation in growth trends during the 1970s; the number of federal civilian employees has actually fallen off since 1969. Government employment as a fraction of the total nonagricultural labor force has also leveled off. From 1949 to 1969, the government's share of the labor force grew from about 14 to over 18 percent, while in the 1970s the share has edged up only a few tenths of a percent. Wages and salaries paid to government workers, however, have continued to grow in comparison to those paid in the private sector. Federal compensation (wages, salaries, and estimated value of fringe benefits) has climbed from about 120 percent to over 140 percent of that of the private sector since 1949, while state and local compensation is now at parity with the private sector. (See Table 3). Of course, public and private jobs differ in their skill requirements and security aspects, but the data presented enable rough comparisons.

Per capita spending has virtually tripled at each level of government since World War II

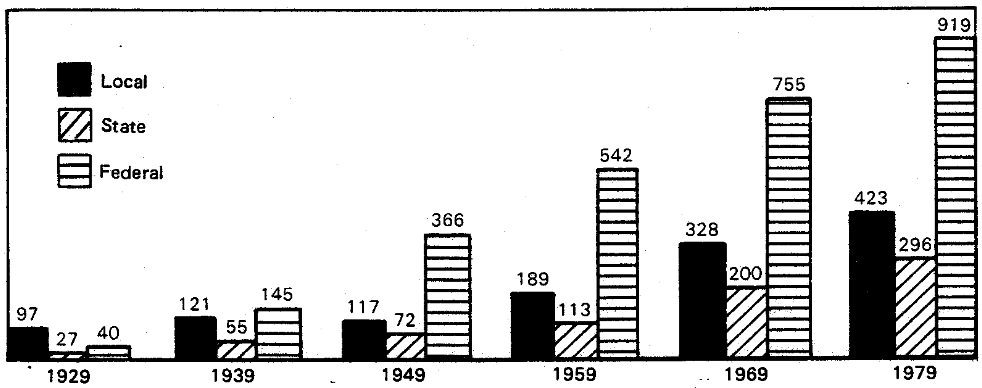

Fig. 2—Per capita spending in 1967 dollars by level of government, 1929-1979

While federal employment has fallen, state and local employment continues to grow at a slackening pace

Table 2

CIVILIAN GOVERNMENT EMPLOYEES BY LEVEL, 1949-1977 (In millions)

Year	Local	State	Federal	Total
1949	3.1	1.0	2.1	6.1
1959	4.6	1.5	3.0	8.5
1969	7.1	2.6	3.0	12.7
1977	9.1	3.5	2.8	15.5

State and local compensation has reached parity with the private sector; federal workers lead by a substantial margin

Table 3

GOVERNMENT COMPENSATION RELATIVE TO PRIVATE SECTOR, BY LEVEL, 1949-78

Year	Ratio of Government to Private Sector Compensation for Full-time Employees: Federal	State and Local
1949	1.21	0.93
1959	1.23	0.92
1969	1.31	1.00
1975	1.42	1.01
1978	1.43	1.00

The fraction of GNP accounted for by federal and local government has begun to turn down

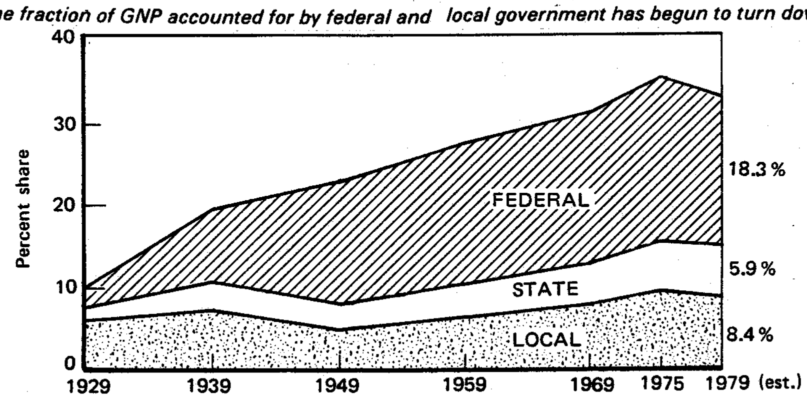

Fig. 3—Spending as a fraction of gross national product, by level of government, 1929-1979

Taxes

Property taxes continue as the mainstay of locally collected revenues, although they now make up only about 80 percent of such revenues whereas in 1948 they accounted for almost 90 percent. The most profound change has been in the growing importance of federal and state grants to local jurisdictions. Just after World War II these transfers provided an additional 50 cents for every dollar of property tax collected locally; grants and property taxes are now about equally important in local government finance (see Fig. 5, which shows the changing role of grants). The fastest growing direct revenue sources are the sales and income taxes collected by state governments. Over time they have absorbed a steadily rising share of personal income: from about 0.5 percent in 1948 to 3 percent currently. As we discuss below, however, the move toward indexing state income taxes may soon cut into this still rising trend.

Programs

Figure 4 shows how the objects of state and local spending have shifted over the last two decades. From 1956 to 1976, health and (especially) welfare expenditures increased disproportionately. During this period those who received Aid to Families with Dependent Children (a variety of welfare) grew from 1.3 percent to 5.2 percent of the population.

Total educational spending maintained a fairly constant share of expenditures. However, the basic component of education, local schools, received a diminished share even though the number of children attending local schools rose faster than the total population, increasing from 31 million in 1956 (18 percent of the population) to 45 million in 1976 (21 percent of the population). Expenditures in higher education and other education grew especially fast, rising from 6 to 11 percent of state and local spending.

Higher education and public assistance tend to benefit more narrowly constituted subpopulations than do such programs as the building and maintenance of highways and streets (whose share has been halved), which are enjoyed by a broad range of taxpayers.

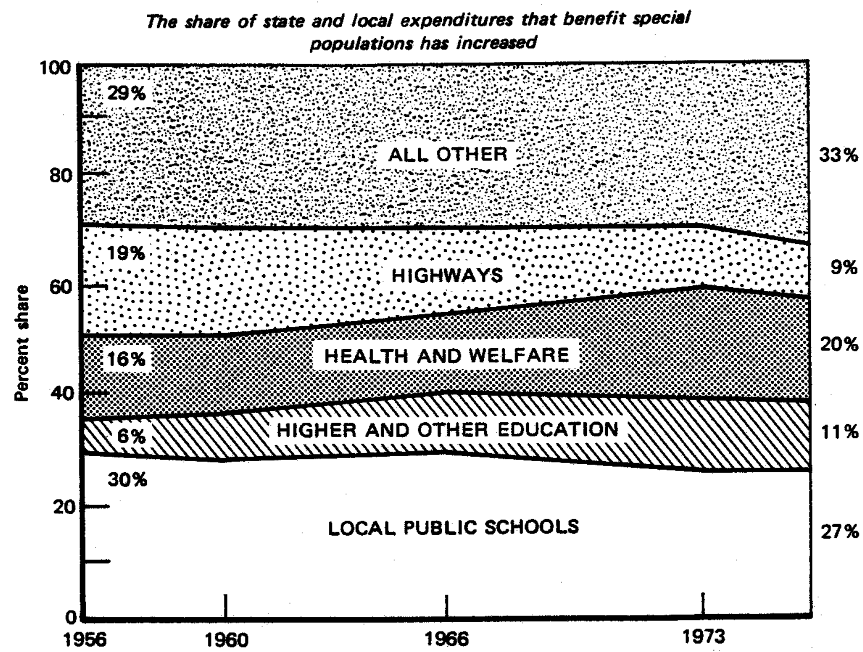

Fig. 4—Percentage distribution of state and local expenditures, by object, 1956-1976
(from R-2494-FF/RC and Advisory Commission on Intergovernmental Relations (ACIR), *Significant Features of Fiscal Federalism*, Vol. 1: *Trends*, M-106, 1976 ed., Government Printing Office, Washington, D.C., November 1976)

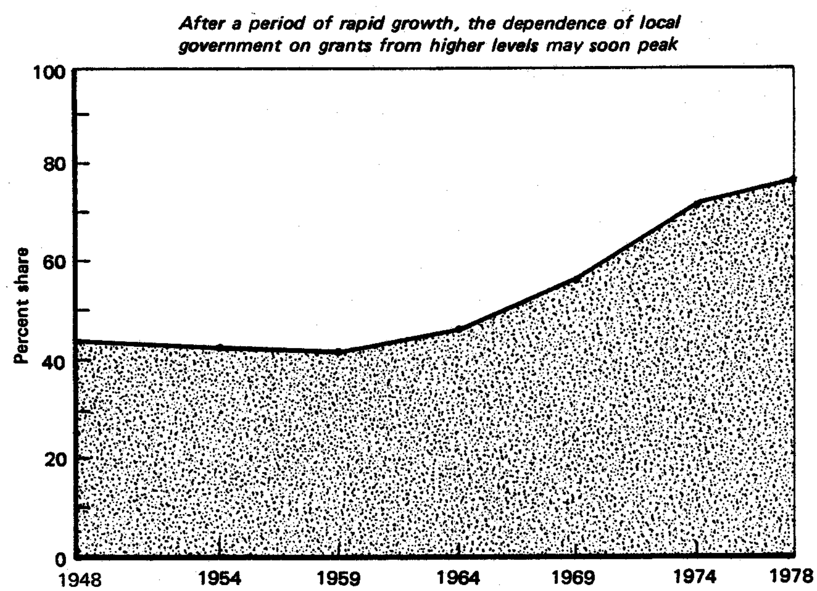

Fig. 5—Federal and state aid to local governments as a fraction of local revenues from own sources, 1948-1978

FISCAL CONTAINMENT

Fiscal containment has numerous causes. In many big cities the tax base shrinks as households and firms depart for the suburbs and the more remote (and less heavily taxed!) regions of the country. Inflation eats away the value of state and federal grants. In inflation-adjusted dollars, aggregate federal and state grants to local governments grew at an annual rate of 8 percent between 1948 and 1975; since then the rate of growth has fallen by almost half, as depicted in Fig. 5, but grants still constitute an expanding share of the total revenues of local government. Should fiscal controls catch on at the state and federal level, grant magnitudes may begin to decline.

Inflation also raises the cost of what governments buy, so that constant-dollar levels of purchases mean declining real levels of service. (However, inflation also expands the base of revenue systems that respond to rises in income, such as income taxes and property taxes in areas where real estate values have been rising disproportionately.) Voters in state and local elections seem increasingly prone to reject spending proposals appearing on ballots, and may have begun to favor the more frugal candidates in elections. Particularly during the 1970s, voters and their elected representatives are being asked to decide not merely on this bond override or that spending proposal, but on broad measures toward fiscal containment.

The Fiscal Limitation Movement

These decisions constitute what we have labeled the fiscal limitation movement. It assumes a variety of forms. Sometimes, as in California's Proposition 13, a particular form of tax levy is cut back. In that case it was the local property tax. (Property tax *rate* limits have a venerable history in American state government; newer is the institution of controls over the total take of the property tax.) Other variants seek to limit state income tax collections by "indexing" them against inflation. More common still are "cap laws" that restrict the growth of state or local spending, or both, to some fraction of aggregate personal income, or to the rate of inflation, or to population expansion. Growth controls appear to generate fewer adjustment problems for state and local governments than do tax cutbacks.

Table 4 lists the limitation measures enacted by 25 states, their dates of enactment, and their characteristics. Twenty-three states have adopted some form of control in the 1970s--16 since 1975. What sort of state adopts fiscal limits? In the past, the prime candidates appeared to be states with high tax burdens (i.e., as a proportion of income) and those with rapidly growing levels of per capita public expenditures. In the last few years the importance of such preconditions seems to have diminished. Fiscal limitation looks more and more like an epidemic whose spread has less to do with tax levels and population characteristics than with the dynamics of the current public mood: disenchantment with government.[1] The

[1]In California, the site of the most drastic of the recently adopted fiscal controls, skyrocketing property tax levies and the existence of a massive state surplus obviously also had much to do with the Proposition 13 landslide.

Half of all states now have fiscal limitation laws; 16 have adopted such laws since 1975

Table 4

STATES WITH GENERAL FISCAL LIMITATION LAWS

	Local Level					State Level				
		Affects:		Type			Affects:		Type	
State	Year	Prop. Tax	Other	Growth	Cutback	Year	Revenues	Expenditures	Fixed %	Variable[a]
Alaska	1976	x		x						
Arizona	1921	x		x		1978		x		x
California	1974,78	x		x	x					
Colorado	1955,71,76	x		x		1977		x	x	
Florida	1971	x		x						
Hawaii	1976	x		x		1978		x		x
Idaho	1978	x			x					
Indiana	1973	x		x						
Iowa	1976	x		x						
Kansas	1970	x		x						
Michigan	1978	x		x		1978	x			x
Minnesota	1971	x		x						
Montana	1974	x		x						
Nebraska	1978	x		x						
New Jersey	1976		x	x		1976		x		
New Mexico	1977	x		x						x
Oregon	1916	x		x						
Rhode Island						1977		x	x	
South Dakota	1978	x		x		1978	x			x
Tennessee						1978		x		x
Texas	1978	x		x		1978		x		x
Utah	1969	x		x						
Virginia	1975	x		x						
Washington	1973	x		x						
Wisconsin	1973	x		x						

[a]As a function, for example, of growth in population, price level, or personal income; or subject to subsequent referendum.

movement has struck in urban states (California) and rural (Idaho); in states where the constitution permits voter-initiated amendments (Colorado) and those where it does not (Tennessee); in states with historically low tax levels (Indiana) and traditionally high ones (Alaska). This phenomenon is less surprising in view of a public opinion poll in 1976 which found that three-fourths of Americans believed that the government wastes a great deal of money; in 1964, only 12 years earlier, only slightly more than half felt that way. By 1978, seven out of ten people believed they were not getting their money's worth from the taxes they paid.

Roots of Taxpayer Discontent

As part of the research underlying this report, we performed a case study of fiscal trends in the City of Los Angeles for the period 1973 to 1978. We were interested in exploring the roots of voter dissatisfaction that may have led to the passage of Proposition 13. Los Angeles has much in common with other big cities in California and, on the spending side at least, its recent history parallels that of many municipalities in other parts of the nation.

Property tax collections increased 53 percent over the five-year span, while total city revenues increased about 72 percent. In the meantime, total employment rose modestly--by 11 percent--and the number of front-line providers of services to the public--police officers, firefighters, and public works (mostly sanitation) employees--hardly changed. But other service categories--such as municipal arts, community development, and recreation and parks--and the overhead agencies, such as staffs of the Mayor, City Council, City Attorney, and Controller, rose about one-third. (See Fig.6.)

In Los Angeles, the number of "front line" agency employees hardly changed over the five years preceding the passage of Proposition 13, while other categories rose by 30 percent

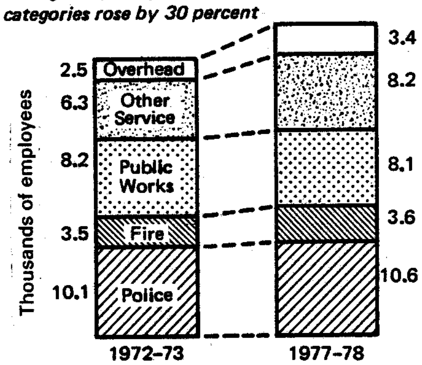

Fig. 6—Employment growth by category, city of Los Angeles, 1973-1978

Where did the money go? Inflation, of course, meant higher costs for employee compensation and other city purchases. The cost of salaries and fringe benefits increased by about 60 percent. These figures seem in line with those experienced by other cities. Inflation was responsible for perhaps 75 percent of the spending increases between 1973 and 1978; but 11 percent was due to what we call "upward grade float"--a relative increase in the number of administrative and indirect personnel compared with direct service providers. Possibly, having more "support" employees increases the efficiency of the "front-liners," but taxpayers have trouble seeing the improvement. Los Angeles now has more support employees than it did in 1973, and they are better than the kinds of direct service providers they supplanted. Los Angeles voters did not possess this sort of detailed information when they cast their ballots for Proposition 13 on June 6, 1978, but they may have had the smoldering conviction that, over time, they were paying more and enjoying it less. Citizens elsewhere may have had similar concerns.

Federal Responses to Fiscal Containment

The federal government has not yet formulated an explicit policy for dealing with state and local grant recipients who have enacted fiscal limitations. Many aid programs require local matching and maintenance of effort, and mandate program standards, which the shrinking of tax bases or the control of spending levels would seem to threaten. So far, however, there have been few, if any, cases of federal funds being withheld because a state or local government could not or would not meet requirements. For the time being, regulations appear to be flexible enough to permit the continued flow of aid.

Whether fiscal controls will emerge at the federal level itself remains an open question. Advocates of various forms of control are becoming increasingly vocal. Their proposals range from tax cuts through mandatory budget balancing to constitutional amendments that tie expenditure increases to the rate of inflation. Should federal limitations come to pass, grant flows to states and local governments may indeed be menaced.

THE SOCIAL AND POLITICAL CONSEQUENCES OF FISCAL CONTAINMENT

Fiscal containment appears to be the wave of the future, but we should beware of possible undertows. California's huge state surplus has cushioned the effects of Proposition 13, and other states' controls are too new or too mild to have had immediate impacts, but real social and political pressures are bound to build up sooner or later. Many of them carry implications for the fair and equitable treatment of special population groups.

Increased Regressivity in Taxes and Charges?

A revenue system is progressive or regressive, depending on the wealth of the groups that shoulder its burdens. Fiscal limits that force cutbacks in a single type of tax may shift these burdens to weaker shoulders. In California, homeowners and businesses have thus far benefited relative to renters. If user charges and the substitution of private for public services emerge as devices to offset property tax losses, high-income households will gain at the expense of those with lower incomes.[2] User charges have already been widely adopted in California for libraries, recreation facilities, land development permits, and museum admissions. Studies of the changing distribution of burdens categorized by household income, location, and tenure would probably show some increase in regressivity.

[2]However, the lower property tax deductions that homeowners can claim in filing their state and federal income tax returns, and the fact that user fees are not deductible, would moderate the regressiveness of the change.

Reductions in Services for the Disadvantaged?

Reductions in service levels also appear likely over the longer term. If officials heed the preferences that citizens express in public opinion polls, programs that benefit relatively small groups--welfare, health care for the indigent, adult education, cultural services--will be the first targets for contraction. Newer services are also likely to suffer because ostensibly they are less valuable activities (in the sense that more important services are established first) and because their clients are less well organized politically than longer established clienteles, such as those for schools and highways. "Fat-cutting" is easy to demand but hard to carry out systematically. Again, equity-oriented research can help provide answers. It would be particularly useful to study jurisdictions that have successfully weathered fiscal containment, to find out what worked and who got hurt.

Arbitrary Cuts in the Public Work Force?

Reductions in government spending imply cuts in public payrolls. Most politicians regard layoffs as a last resort, partly because public employees are active politically; there is much more appeal in hiring-freezes and reductions in real (i.e., inflation-adjusted) compensation. A common public opinion holds that many government employees are redundant and that many are overpaid. In California, terminations have been negligible but attrition reduced total public employment by 104,000 jobs, or 6 percent, in the year following Proposition 13's passage; and state and local wages in the past couple of years have lagged behind inflation. Freeze strategies can effectively reduce public payrolls, but when applied across the board they are arbitrary, in the sense that they primarily prune those governmental functions that have highly senior work forces (employees close to retirement) or that employ people who will have little trouble switching to jobs in the private sector--often the young and mobile. Older, less mobile, people who have made a career in civil service may be hurt the most by reductions in real compensation.

Fewer Opportunities for Minority Employment?

Cutbacks in public sector jobs will affect minorities disproportionately. Because they commonly enjoy the least seniority, civil service regulations and union agreements will force them to bear the brunt of any layoffs. Many city governments employ a surprisingly large fraction of minority professionals and skilled workers--often double the fraction in the general labor force. The availability of higher-status jobs for blacks and Hispanics has been growing more rapidly in the public sector than in the private. Hiring freezes threaten to dislodge this stepping-stone into the middle class for minorities; a leaner and smaller public sector may also turn out to be meaner and harsher.

Loss of Local Control?

Although fiscal containment appeals to conservatives, one of its side-effects may displease them. As local sources of revenue dwindle, pressure will mount for larger grants from higher-level government, notably the state. Affected client and employee groups will apply a great deal of that pressure. State government may indeed be increasing its importance in the aid system relative to the federal and local levels, where the disadvantaged have historically found their most vocal advocates. Thus far, however, state governments have been loath to assume operational responsibility for local programs, but political and bureaucratic imperatives may push them into doing so; and in the long term, control tends to follow hard on the heels of finance. As higher-level governments bail out needy localities, home rule--the responsiveness to local concerns--may be the ultimate victim.

CONCLUDING REMARKS

Disgruntled taxpayers have delivered a message to government through a variety of instruments, including the ballot box and the moving van. That message will affect the future size and shape of the public sector, because the broad middle range of Americans currently seem to favor scaled-down government. They may benefit from the same fiscal restraint that threatens groups who lack clout in numbers, wealth, or organizational effectiveness. These groups may have to surrender some of the appreciable benefits they derived from the postwar expansion of government. The threat is particularly serious for the disadvantaged. Policymakers, in responding to the mood of the nation, are in danger of sacrificing equity in their quest for frugality and efficiency in government.