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Another Round of Fend-for-Yourself Federalism

It began with the president’s “skinny” budget for fiscal year (FY) 2018, and it is continuing with chatter around tax reform. “It” is the notion that state and local governments are about to see an escalation of fend-for-yourself federalism.

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ANOTHER ROUND OF FEND-FOR-YOURSELF FEDERALISM

> “The idea of 'levels of government’ - with the Federal Government supreme, as it was for half a century - is fading, according to the Advisory Commission on Intergovernmental Relations, a nonpartisan research agency. What has emerged, said John Shannon, executive director of the federally financed agency, is a ''fend-for-yourself'' system.” – John Herbers, *The New York Times*, June 14, 1987

It began with the president’s “skinny” budget for fiscal year (FY) 2018, and it is continuing with chatter around tax reform. “It” is the notion that state and local governments are about to see an escalation of fend-for-yourself federalism. Simply put, the possibility of federal retrenchment from providing tax and spending support could leave state and local governments to decide how to fend for themselves going forward.

THE SPENDING SIDE

It may have been only 62 pages long, but the president’s FY 2018 budget blueprint, released in March, sent a powerful message to state and local governments. The following proposals were specified in *America First: A Budget Blueprint to Make America Great Again*:

- Eliminate or reduce more than 20 categorical education programs.
- Eliminate the Weatherization Assistance Program and the State Energy Program.
- Eliminate the Low Income Home Energy Assistance Program and the Community Services Block Grant.
- Eliminate or reduce state and local grant funding for programs administered by the Federal Emergency Management Agency.
- Eliminate and reduce unauthorized and “underperforming” programs administered by the Transportation Security Administration, including grants to state and local jurisdictions.
- Eliminate funding for the Community Development Block Grant.
- “Promote fiscal responsibility” by eliminating funding for “lower priority” housing programs, including HOME Investment Partnerships, Choice Neighborhoods, and the Self-Help Homeownership Opportunity Program.
- Eliminate spending on the “poorly targeted” State Criminal Alien Assistance Program.
- Reduce funding for job training grants.
- Limit funding for the Federal Transit Administration’s Capital Investment Program to projects with existing full funding grant agreements only.
- Eliminate funding for the TIGER discretionary grant program.
- Eliminate or substantially reduce federal investment in state environmental activities.
- Eliminate funding for the Great Lakes Restoration Initiative, the Chesapeake Bay, and other geographic programs.
- Eliminate more than 50 Environmental Protection Agency programs.
- Zero out more than $250 million in National Oceanic and Atmospheric Administration grants and programs.

The justifications for these proposals is familiar to those who have been around long enough to observe previous iterations of this exercise:

- Eliminate programs that do not address national needs, that duplicate other programs, or that are more appropriately supported with state, local, or private funds.
- Reduce federal intervention in state-level policy.

- Curtail activities that exceed statutory requirements.
- Eliminate programs that are unauthorized or that supplant state and local spending.
- Acknowledge that state and local governments are better positioned to serve their communities based on local needs and priorities.
- Eliminate outdated programs that have met their goal or exceeded their usefulness.
- Terminate programs that are not well-targeted and have not demonstrated results.

Federal Funds Information for States (FFIS, publisher of *Reports*), identified 26 programs or agencies specifically targeted for elimination, representing more than $16 billion in FY 2017 funding. The table on the right shows that proposed cuts account for an average of 9% of total discretionary grant funding tracked by FFIS.

The table also shows that northeastern and upper midwestern states would be hit hardest by the cuts proposed so far, owing largely to the proposed elimination of the Low Income Home Energy Assistance Program, which largely benefits cold-weather states. A more complete budget proposal is expected in May, which could include additional proposed reductions and eliminations.

THE TAX SIDE

Also expected in May is a more complete tax reform proposal. To date, only a broad outline of tax reform principles has been released. State and local governments have been focused on two federal tax policies that benefit them: the exclusion of interest on tax-exempt municipal bonds from federal taxation, and the deductibility of state and local taxes on federal tax returns. (The latter has been identified as a target of federal tax reform.)

The interest exclusion is important because it reduces the interest rate governments must offer for the municipal bonds that finance much capital spending. Its repeal would raise government borrowing costs.

Programs Targeted for Elimination in FY 2018 Budget Blueprint as a Percent of Discretionary Funding

Rank	State	Percent
1	Maine	14.7%
2	Massachusetts	13.4
3	New Hampshire	13.3
4	Michigan	12.1
5	Wisconsin	12.0
6	Minnesota	12.0
7	Vermont	12.0
8	Pennsylvania	11.5
9	Iowa	11.3
10	Rhode Island	11.3
11	Ohio	11.2
12	New York	10.9
13	Connecticut	10.9
14	Puerto Rico	10.4
15	Illinois	10.1
16	Delaware	10.0
17	Indiana	9.7
18	Missouri	9.7
19	Nebraska	9.7
20	West Virginia	9.5
21	New Jersey	9.4
22	North Dakota	9.3
23	Maryland	9.2
24	Kentucky	9.1
25	Kansas	9.1
	State Average	**9.0**
26	Louisiana	8.9
27	Mississippi	8.8
28	North Carolina	8.7
29	District of Columbia	8.6
30	South Dakota	8.5
31	Virginia	8.5
32	Colorado	8.2
33	California	8.2
34	South Carolina	8.2
35	Oregon	8.2
36	Tennessee	8.2
37	Idaho	8.1
38	Alabama	8.1
39	Arkansas	8.1
40	Washington	7.7
41	Utah	7.6
42	Oklahoma	7.6
43	Georgia	7.3
44	Texas	7.3
45	Florida	7.3
46	Wyoming	7.2
47	Arizona	7.1
48	New Mexico	6.9
49	Montana	6.8
50	Nevada	6.6
51	Hawaii	5.6
52	Alaska	3.5

The deduction for state and local taxes (primarily income, property, and limited sales taxes) is a little peskier. The benefit doesn't reduce state and local tax burdens directly; instead, it reduces federal tax burdens, which in theory allows state and local governments to levy higher taxes than they otherwise could.

The tax benefit—or tax expenditure, as it is termed among budget analysts—is expensive. A recent paper from the Tax Policy Center put the cost to the federal government at $96 billion in foregone revenue in FY 2017, with 60% of the deduction accounted for by income taxes, and 35% by property taxes.

It also is narrowly targeted, as it is claimed by only the 30% of federal tax filers who itemize deductions. Moreover, while about 10% of filers with income less than $50,000 claimed the deduction, 81% of filers with incomes greater than $100,000 claimed it.

Like federal grant spending, this tax benefit is more important to some states than others. The table on the right estimates the share of tax filers that would see their federal taxes increase if the deduction were eliminated. It ranges from 39% in **Maryland** to 12.8% in **South Dakota**.

ZOOMING OUT

To be sure, state and local governments benefit from both federal spending and tax policies, and some benefit more than others. That's in part by design and in part by happenstance. The design flows from the economic underpinnings for federal taxes and spending, including:

- ✓ Redistributing income to level the playing field among jurisdictions
- ✓ Tackling externalities, or the effects of actions taken in one jurisdiction but felt in another (such as pollution)

Share of Tax Filers Affected by Repealing the State and Local Tax Deduction, 2016

Rank	State	Percent
1	Maryland	39.0%
2	Connecticut	34.9
3	New Jersey	32.9
4	Virginia	32.5
5	Massachusetts	32.1
6	District of Columbia	31.6
6	Minnesota	31.6
8	Utah	29.6
9	Colorado	29.0
9	Oregon	29.0
11	Delaware	28.0
11	New Hampshire	28.0
11	Rhode Island	28.0
14	Wisconsin	27.8
15	New York	26.9
16	Illinois	26.6
17	California	26.2
18	Iowa	25.4
19	North Carolina	25.2
20	Maine	24.9
21	Nebraska	24.4
22	Georgia	24.2
23	Washington	24.1
24	Ohio	24.0
25	Vermont	23.6
	United States	**23.6**
26	Pennsylvania	23.5
27	Idaho	23.4
28	Hawaii	23.0
28	Montana	23.0
30	Arizona	22.9
31	Kansas	22.5
32	Missouri	22.4
33	South Carolina	22.2
34	Michigan	21.7
35	Kentucky	21.4
36	Alabama	20.6
37	Oklahoma	19.3
38	Indiana	19.0
39	Alaska	18.4
40	Arkansas	18.1
41	New Mexico	17.8
42	Louisiana	17.2
43	Mississippi	17.1
43	Nevada	17.1
45	North Dakota	16.5
46	Texas	16.2
47	Wyoming	15.0
48	Florida	14.9
49	Tennessee	14.8
50	West Virginia	13.6
51	South Dakota	12.8

Source: Tax Policy Center

- ✓ Economies of scale, because it's sometimes more efficient to build and maintain one big system or program rather than many smaller ones (such as defense agencies)

The part that isn't by design more likely reflects specific priorities of certain members of Congress or successful lobbying by special interests.

The extent to which federal tax and spending policies change the state-local landscape is best measured by comparing how much each state receives in federal spending to how much it provides in federal revenue. Often called the "balance of payments" with the federal government, states use this measure to evaluate whether they are net recipients or donors of federal funds.

For many years, the analysis was released by the late Senator Moynihan (New York). The Tax Foundation carried on the analysis for a time, but eventually stopped. The New York State Comptroller's office updated the analysis in 2015, based on data from federal fiscal year (FFY) 2013.

The table on the right reflects that analysis. The results show the combined effect of redistributive spending policies—which send more grant dollars to states with greater need—and a progressive federal tax structure, which imposes higher tax rates on those with higher incomes.

As a result, states with high need and low incomes, such as **Mississippi**, **New Mexico**, **West Virginia**, **Alabama**, and **Kentucky** get more than $2 in return for every $1 they send to Washington. At the other extreme, 10 high-income, low-need states get less than $1 back for every $1 they remit: **New Jersey**, **Wyoming**, **Connecticut**, **Minnesota**, **New York**, **Illinois**, **Massachusetts**, **New Hampshire**, **North Dakota**, and **California**.

(Note that the "average" state gets $1.22 in spending for every $1 it pays in taxes. If the federal budget were balanced, spending would equal revenues, so the average would be $1. Because the federal budget is in a deficit, most states come out ahead.)

Federal Spending per Dollar of Taxes Paid, FFY 2013

Rank	State	Amount
1	District of Columbia	$3.97
2	Mississippi	2.57
3	New Mexico	2.34
4	West Virginia	2.11
5	Alabama	2.08
6	Kentucky	2.01
7	Maine	1.87
8	South Carolina	1.85
9	Hawaii	1.76
10	Arkansas	1.74
11	Virginia	1.69
12	Idaho	1.67
13	Arizona	1.59
14	Tennessee	1.58
15	Missouri	1.56
16	North Carolina	1.53
17	Maryland	1.47
18	Louisiana	1.47
19	Oklahoma	1.45
20	Alaska	1.45
21	Montana	1.40
22	Georgia	1.39
23	Vermont	1.37
24	Ohio	1.36
25	Michigan	1.32
26	Indiana	1.32
27	Florida	1.29
28	South Dakota	1.28
29	Pennsylvania	1.28
30	Rhode Island	1.27
31	Oregon	1.26
32	Delaware	1.23
	United States	**1.22**
33	Kansas	1.15
34	Iowa	1.15
35	Nevada	1.14
36	Utah	1.14
37	Texas	1.11
38	Washington	1.09
39	Wisconsin	1.08
40	Nebraska	1.00
41	Colorado	1.00
42	California	0.99
43	North Dakota	0.97
44	New Hampshire	0.93
45	Massachusetts	0.92
46	Illinois	0.91
47	New York	0.91
48	Minnesota	0.86
49	Connecticut	0.83
50	Wyoming	0.81
51	New Jersey	0.77

Source: Reports, *based on New York State Comptroller*

The table provides insight—but not a definitive answer—into how individual states might fare as a result of more fend-for-yourself federalism. In theory, those states at the top of the table would stand to lose the most from cuts in federal spending, but it would depend on the programs targeted for reduction. And in theory, the states at the bottom of the table would stand to gain from a net reduction in federal income taxes, but it also would depend on the specific policies.

What seems likely is that a successful effort to cut federal grant spending while simultaneously reducing federal taxes would do the least harm—and potentially bring benefits—to higher-income states. At the same time, states with lower incomes would see larger relative cuts in grants—many of which target low-income people or communities—while seeing less advantage from tax cuts.

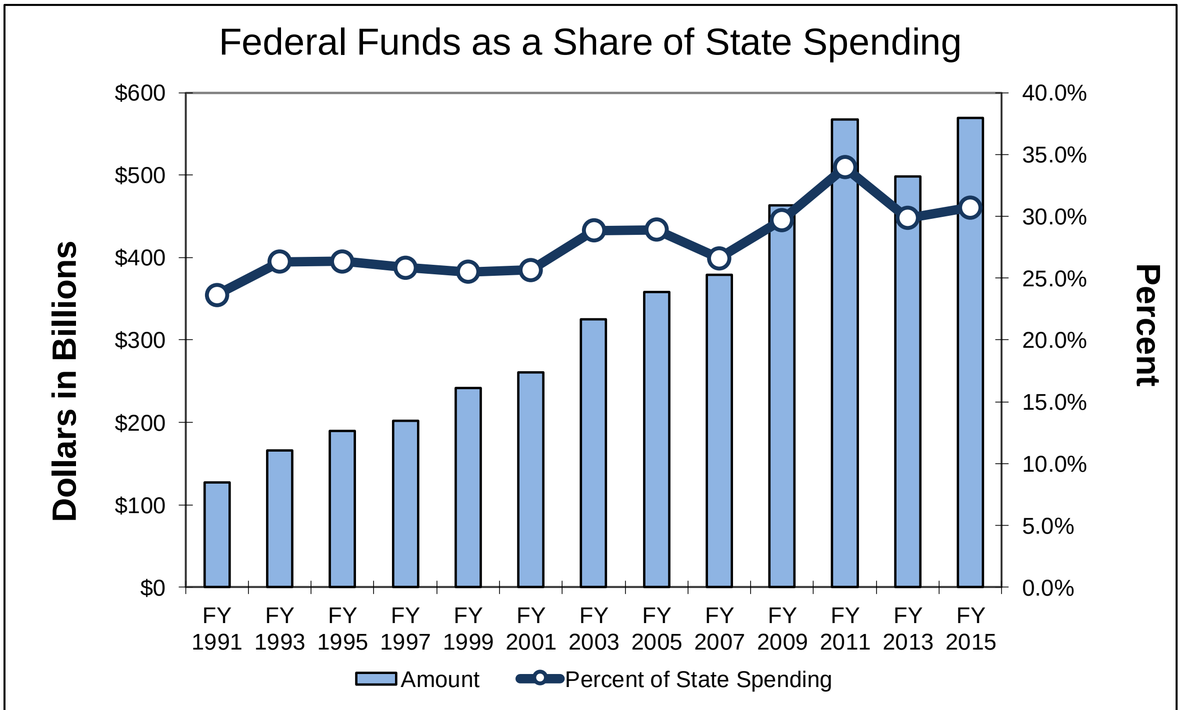
BUT WAIT!

This article is premised on the notion that current efforts to reduce federal grants represent "another round" of such cuts. Skeptics might ask how that can be, if the federal share of state spending keeps going up, as the chart below suggests.

Indeed, the share has been increasing, but only because of Medicaid. Outside that program, federal aid to state and local governments has been on a downward trend for years.

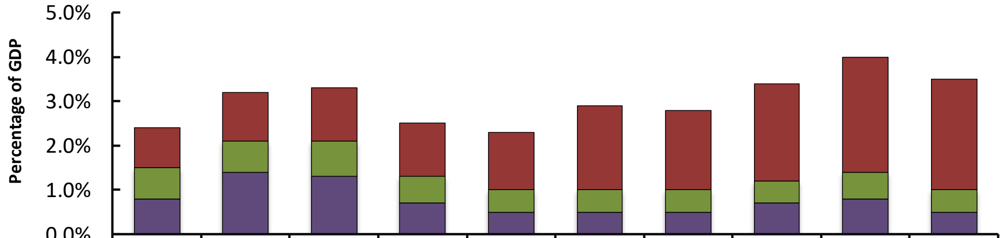
The chart and table on page 7 show federal grants to state and local governments at five-year intervals going back to FY 1970. Such grants totaled 2.4% of gross domestic product (GDP) in FY 1970, rising to 3.5% in FY 2015. However, the only category that grew unabated was payments to individuals, of which Medicaid is the lion's share.

Grants targeted to places and things rather than people declined from 1.5% of GDP in FY 1970 to 1% in FY 2015. The heyday of such aid was the late 1970s through FY 1980, when capital and other grants exceeded 2% of GDP. The first iteration of fend-for-yourself federalism drove that share down to 1.3% just five years later, and the downward trajectory has largely continued, especially for capital spending. (The FY 2010 bump reflects one-time assistance provided through the American Recovery and Reinvestment Act.)



Source: NASBO State Expenditure Report, various years

Federal Outlays for State and Local Grants as a Share of GDP



	FY 1970	FY 1975	FY 1980	FY 1985	FY 1990	FY 1995	FY 2000	FY 2005	FY 2010	FY 2015 est.
Individuals	0.9%	1.1%	1.2%	1.2%	1.3%	1.9%	1.8%	2.2%	2.6%	2.5%
Capital	0.7%	0.7%	0.8%	0.6%	0.5%	0.5%	0.5%	0.5%	0.6%	0.5%
Other	0.8%	1.4%	1.3%	0.7%	0.5%	0.5%	0.5%	0.7%	0.8%	0.5%

Source: OMB Histrorical Tables, FY 2016

With respect to prospective federal budget and tax reform, the devil will be in the details, and those details have yet to released. According to reports, complete budget and tax plans will be released in May. They will specify a more exhaustive list of grant programs and taxes slated for increases and decreases in the coming years. With such information, analysts will better be able to discern the likely impacts of the proposals on the state-local community in general, and on specific state and local governments.

TECHNICAL NOTES

Federalism. Detailed estimates of state cuts under the FY 2018 budget blueprint appeared in FFIS *Issue Brief 17-06*, available to subscribers at www.ffis.org. *Revisiting the State and Local Tax Deduction* and *Repeal of the State and Local Tax Deduction* are available at www.taxpolicycenter.org.

The New York State comptroller's report on the state-federal balance of payments can be found here: http://osc.state.ny.us/press/releases/oct15/102715.htm.

The National Association of State Budget Officers *State Expenditure Reports* are at www.nasbo.org, and the OMB *Historical Tables* can be located at www.gpo.gov/fdsys/pkg/BUDGET-2016-TAB/pdf/BUDGET-2016-TAB.pdf.

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