A LESSON IN FISCAL FEDERALISM

The father of sound money management reflects on how tax policies shifted the state-federal balance.

BY BILLY HAMILTON

Sometimes even success has its pitfalls. Just ask John Shannon, who spent 24 years in a variety of roles at the U.S. Advisory Commission on Intergovernmental Relations. He recalls with wry humor how one state that had asked for advice on crafting a tax law had used the recommendations.

"One state copied verbatim into state law our suggested income tax legislation—even the drafting instructions we had enclosed in parentheses!"

For many people working in state and local finances, Shannon was *the* voice of the ACIR, created by Congress in 1959 as a bipartisan body to study the relationship among local, state and national governments, and especially to look at fiscal issues. Congress disbanded it in 1996.

A little north of 80, Shannon retired from the advising profession a decade ago. But talking with him now about the changes over his career is a history lesson in how federal, state and local fiscal relations came to be what they are today.

"There is much to be learned from 50 years of working around government at all levels," he says. "When I was a graduate student in the late 1940s, we were coming out of two back-to-back super crises—the Great Depression and World War II. The federal government had suddenly emerged as the colossus looming over the federal-state-local landscape."

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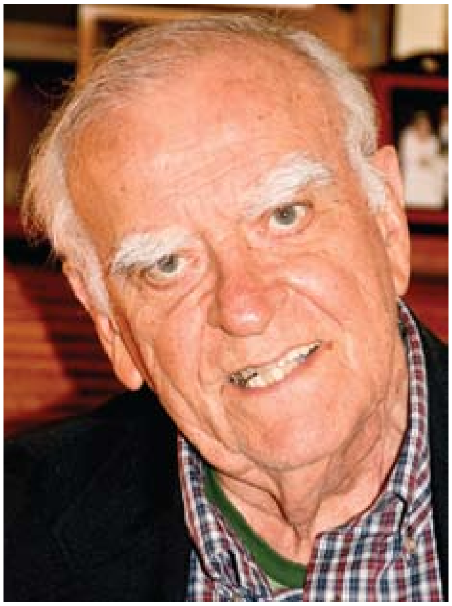

In 1932, he says, the state-local sector was the senior partner in the federal fiscal system, collecting 78 percent of all governmental taxes. Twenty years later, state and local governments were collecting only 21 percent of all governmental tax revenue.

In this period, there was high confidence in Washington and very low confidence in the states.

"Back in the late 1940s, many public finance and political science professors—especially those of a liberal political bent—were predicting that the states would soon either wither away or become mere administrative appendages of the federal government," says Shannon.

"Not only was Washington's stock booming, the states were going through a bad patch—they looked like the 'fallen arches' of the American federal system. The doctrine of states' rights still justified Jim Crow laws, many state legislative bodies were malapportioned, and—in striking contrast to the federal situation—the state and local revenue systems were viewed as weak, regressive and severely hobbled by the fears of interstate tax competition."

STATE RESILIENCY

Shannon confesses that he shared this gloomy view of the states' future.

"Were we wrong! Fortunately, the states and localities have proved far more resilient and the federal government far less formidable than we ever imagined. Now 60 years later, Jim Crow laws have disappeared, state legislatures have been reapportioned, and the state-local revenue system is generating about $1 trillion annually in its own source general revenue—a sum greater than the gross national product of most members of the United Nations."

Shannon says the resurgence of the states, ironically enough, can be traced to their crisis-driven actions during the Depression.

"Just as the Depression forced an enormous expansion in federal regulatory power on the domestic front, it also forced an unprecedented expansion in state tax adoptions—16 individual income taxes, 15 corporate income taxes, 24 general sales taxes, 29 distilled spirit taxes and 19 cigarette taxes."

Virtually all of these "emergency" levies then became permanent additions to state revenue structures. They now account for a good share of the states' revenue take—what Shannon calls "the sheet armor of fiscal federalism."

OVERRATING WASHINGTON

"Just as we badly underrated the resilient states back then, so also we badly overrated Washington's ability to take over much of the financing of the domestic public sector," Shannon says.

This miscalculation was due in part to a great shift in public opinion. "By 1980, a majority of the voters appeared to agree with Reagan's contention that government—especially the federal government—had become the problem not the solution."

But it was in the revenue-raising area, Shannon emphasizes, where federal income tax enthusiasts really went wrong.

"We thought that, unconstrained by fears of competition, the powerful and progressive federal income tax could and should largely replace the weak and regressive state-local tax system. We soon discovered that in peacetime the federal income tax potential was far more apparent than real.

"Why? Because of the powerful constraints imposed on it by American politics. When the Democrats are in power, they show no enthusiasm for raising the income taxes of the masses—the non-rich. When the Republicans are in power, they are constantly trying to cut income tax burdens, especially those of the rich."

Shannon also points out that back in the 1940s, no one dreamed that Congress would come to rely on deficit financing to paper over chronic revenue shortfalls. One of the members of the ACIR, Ohio Congressman Clarence Brown Jr., summed up the situation neatly: "We jumped into the Keynesian roadster and discovered it had a powerful accelerator but no brake."

In sharp contrast, Shannon says, "State and local officials have no such roadster. Even if there were no state laws prohibiting it, state and local governments dare not rely heavily on deficit financing. Why? Unlike the feds, they would be hard-pressed to find lenders willing to finance their deficits at low interest rates. So they have to act responsibly and keep revenues and expenditures in fairly close alignment—a classic case where legal and economic necessity combine to produce state and local fiscal virtue."

INTERSTATE COMPETITION

Many students of public finance take a very dim view of interstate competition for economic development—describing it as a "zero-sum game." Shannon admits that at one time he shared this attitude. Gradually, though, he says he came around to the idea that interstate competition helps more than it weakens the federal system. Competition works powerfully on the spending side of the state and local fiscal equation.

"To be competitive, jurisdictions must have good schools, roads and recreational facilities. Thus, competitive emulation forces states to stay at least fairly close to their pace-setting neighbors," he says.

Interstate competition for economic development can look destructive, he says, "but when viewed from a national perspective and over time it looks more like 'constructive destruction.' To put this equalizing effect most bluntly—poor states are hungry states and hungry states are usually the toughest competitors."

AN EAR FOR A CATCHY PHRASE

John Shannon joined the U.S. Advisory Commission on Intergovernmental Relations a few years after it was formed in 1959. He served as a senior analyst, assistant director of the public finance staff and, finally, as the commission's executive director.

Shannon coined such memorable phrases as "fend-for-yourself federalism," state "fiscal blood pressure" readings, property tax "circuit breakers" to shield low-income homeowners from property tax overloads, and "sore thumbs" to describe the problems in state tax systems that hurt economic development efforts. His was the recognizable name on "Significant Features of Fiscal Federalism," one of the commission's best and most sorely missed reports.

He retired from the ACIR in 1986, moving on to a stint at the Urban Institute before retiring a decade ago.

MODERATION, ESPECIALLY IN TAXATION

The ACIR urged states and their localities to rely on a "three-legged stool" of income, sales and local property taxes to finance most of their services.

"That was one of the great contributions of the ACIR," Shannon says. "Only a few states—like oil-rich Alaska with its severance taxes and tourist-rich Nevada with its gaming and sales taxes—can do what every state would like to do: shift most of its tax burden on to nonresidents. For the great majority, operating in a highly competitive environment, the best tax system is one that makes moderate use of each of the big three—property, income and general sales taxes.

Shannon says this argument, in its early incarnation, ran counter to the conventional public finance wisdom that favored a progressive income tax as a primary source for state and local financing.

"We have learned, though, that it is very risky for a state to lean too heavily on any one of the big three. Why? Because each of these taxes has it own set of advantages and disadvantages. The more you push down on any one of them, the more obvious become its weaknesses and the less obvious its strengths.

"You know," Shannon continues, "if you think about the situation today, I would say that the old three-legged stool has now become a four-legged table. As taxpayers become resistant to higher taxes, states and localities are resorting to an increasing array of user charges and fees to finance the expansion of public services … because they are the least objectionable way to squeeze out more dollars from the public."

But, he adds, if you lean on such fees too heavily, you again run into the same regressive issue found in the sales tax.

Shannon says that major tax changes come only in times of significant fiscal crisis—particularly severe and sustained revenue shortfalls. Only then can governors and legislatures dare to make significant changes in their tax structures. Even then a crisis provides only a partial political heat shield for lawmakers, he says.

"The long road to stronger state revenue systems is paved with the political bones of courageous former governors."

CHECK OUT two studies on the advantages and disadvantages of state economic incentive strategies at www.ncsl.org/magazine.