Northern Virginia

Deficits All Around: The Need for Intergovernmental Collaboration

A Report of the Northern Virginia Fiscal Advisory Council

December 7, 2009

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The Northern Virginia Fiscal Advisory Council was convened by George Mason University and The Concord Coalition to bring community leaders together to examine the nation's fiscal, health care and economic challenges. With leaders from state and local government, nonprofits, health-care providers and private businesses, the advisory council has held a series of meetings this year engaging the public in dialogue about the difficult issues facing the nation and our communities.

The council organized a "Fiscal Wake-Up Tour" program in which national policy experts visited the campus of George Mason University to discuss the economic threats posed in the short term by the recession and in the longer term by the retirement of the baby boom generation. We presided over a forum that brought together students, older citizens and medical providers for a wide-ranging discussion about the unsustainable growth of health care costs and the implications of reform for Northern Virginia. A third forum was held in October to hear from Northern Virginia's congressional delegation, with the goal of opening up a dialogue between elected officials and community leaders.

From our meetings and deliberations, the Council developed this white paper summarizing the collective perspective of community leaders on the consequences of national policies, both for today and over the longer term.

The Bottom Line

We find an urgent need for dialogue and partnership among federal, state and local governments to resolve the growing gaps between spending commitments and tax resources at all levels of government. These gaps have common sources: rising health care costs, burgeoning retirement benefits, slower economic growth and lagging government revenue. Even as we emerge from a deep recession, these problems will continue to undermine the fiscal foundations of governments. While economic recovery will be most welcome, the fiscal relief will be both temporary and increasingly fragile.

The structural fiscal gaps facing all levels of government are unprecedented in magnitude and increasingly interconnected. Policies and actions of each level of government affect the fiscal and economic prospects of us all. Since the problems spill over the boundaries of our federal system, each level of government acting alone will not be able to deal effectively with the root causes. Go-it-alone strategies may only push problems to other jurisdictions, leaving the public confused and frustrated. Concerted and coordinated action across the levels of government in our federal system provides the best prospects for resolving the fiscal challenges in the most expeditious and effective manner.

The Fiscal Challenges

These are the most difficult times for federal, state and local governments since the Great Depression. The federal deficit has exploded into the largest postwar deficit in our history. Recent estimates show that deficits have increased to over 11 percent of the economy, thanks to collapsing revenues and expanding costs from stimulus spending and the automatic stabilizers built into federal programs.

State tax collections dropped by more than 16 percent in the second quarter of 2009, the sharpest decline on record, according to the Rockefeller Institute. Virginia cut spending by nearly six percent in 2009 and the governor has announced further cuts during the 2010 fiscal year. Arizona, hit by the full-gale force of the real estate crisis, has cut spending by one third over the past several years. The recession cut into state income and sales tax revenues most directly, and local governments are now struggling with less state aid and lower property tax receipts resulting from the collapse of housing prices.

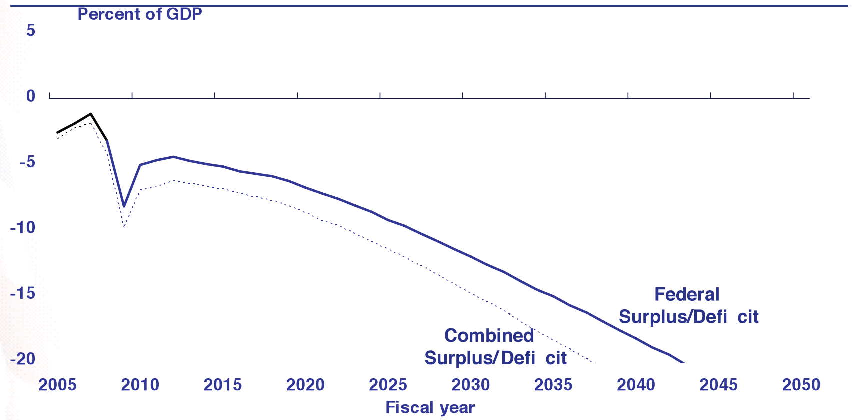
The federal stimulus program has provided some significant relief to the state and local sectors thanks to reductions in state matching required for Medicaid and the state stabilization fund. However, state and local governments will still be mired in a deep fiscal rut once these federal funds expire in FY 2011. As federal grants, including the stimulus, have grown to become the largest single revenue source for state and local governments, federal actions to resolve national deficits by reducing grants, including the end of stimulus funds, will have a particularly wrenching effect on the state and local sectors. Even as the economy recovers, state and local governments will experience a fiscal lag, as slow job growth characteristic of recoveries causes spikes in state Medicaid spending while continuing to depress revenues.

Once the economy recovers, analysts project that budgets at all levels of government will face even more daunting long-term structural deficits. Absent fundamental reforms of spending and tax policies, the spending commitments for an aging society will rapidly overwhelm the revenues available to finance them. Escalating federal health care and Social Security costs as well as rapid acceleration of interest costs to finance burgeoning federal debt will together cause deficits to escalate to over 20 percent of GDP in the next several decades.

This long-term fiscal scenario is compounded by the slower economic growth expected in the future, thanks to a decline in workforce growth. Simply put, we have not had enough children to provide the workforce to support the growth levels to which we have become accustomed. Most analysts project that economic growth at full employment will slow from over three percent to two percent in the next several decades. This means less tax revenue.

Just like the federal budget, state and local budgets are on an unsustainable course. Even once the recession is over, the U.S. Government Accountability Office reports, state and localities will face a long-term structural deficit that will exceed three percent of the economy by 2050.

State and Local Fiscal Challenges Add to the Federal Government's Fiscal Challenge



Source: GAO January 2009 analysis.

[a]Federal surplus/deficit is from GAO's Alternative Simulation using the Trustees' assumptions.

As with the federal budget, the primary culprit in long-term state and local imbalances is rising health care costs. The states are chained to the health care crisis by their financing role in Medicaid as well as insuring their own employees. States and localities also face unfunded employee pension costs and a revenue system that fails to keep pace with the sources of growth in the economy. In general, states and localities cannot run deficits in their general funds. So the chronic fiscal deficits projected over the longer term indicate the size of the spending cuts and tax increases that state and local officials will have to impose over many decades.

State and local governments, as well as their federal counterparts, can't simply grow their way out of this structural fiscal gap through economic growth or full employment. Rather, the answers lie in complex and difficult choices on the tax and spending sides of the budget of all levels of government.

The federal government has been able to sidestep fiscal constraints in recent years. This is partly due to the markets' willingness to finance increasing levels of federal debt, a pattern that actually was reinforced during the recession as investors sought out the relative safety of U.S. Treasuries. However, a growing share of the federal debt is held by foreign governments and individuals. As economies recover throughout the world, finance officials in China and other nations have indicated concerns about our mounting deficits. They may opt to invest their savings elsewhere, raising interest rates for the federal government. Such international market pressures have forced other nations such as Sweden, Australia and Canada to eliminate their deficits and actually run surpluses. These pressures may ultimately force national leaders to change our federal fiscal course as well.

Growing Interdependence

Elected officials must come to grips with these challenges at a time when the spending and revenues of different levels of government have become increasingly intertwined. State and local governments, employing nine times as many employees as the national government, have become the real workhorse of public governance. They are vital partners in implementing many major federal programs, including those involving welfare, health care and environmental protection. Federal reliance on state and local capacities has accelerated in the past five years, bringing new tensions. Federally devised efforts have extended into policy areas once controlled primarily by lower levels of government – elections administration, fire departments, educational quality and motor vehicle licensing, among others.

State and local governments have become more dependent on federal aid to fund key services. Federal grants have grown to comprise over 25 percent of state and local revenues. In an historic first, federal government assistance to states and local governments has supplanted sales, property, and income taxes as their biggest source of revenue. Fiscal interdependence is highest for the states; it appears that, with the stimulus, federal assistance will comprise 41 percent of all state revenues through 2010. Washington, with its ability to tap the revenues of the entire national economy, can help compensate for the limited reach of state and local government tax systems. However, in contrast to general revenue sharing, nearly all federal grants are conditional and restricted to narrow purposes. Accordingly, states and localities must accept a growing range of federal policy goals and regulations.

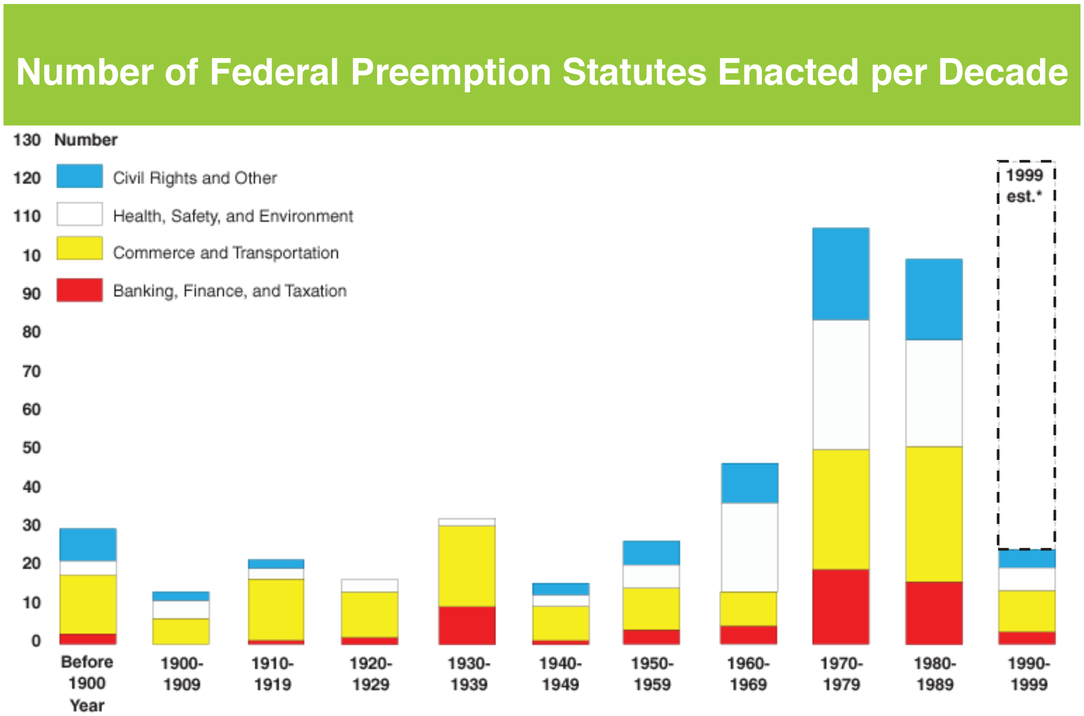
Federal Policy Responses to Public Demands

Federal leaders have come to be at the center of a maelstrom of public demands for governmental actions to respond to an increasing range of problems, ranging from climate change to health care to education. In each of these areas, and many others, strong pressures from interest groups and national political leaders themselves call for federal action in areas with longstanding and significant state and local involvement.

The federal government has three choices when dealing with state and local governments in these areas: defer to state and local policymakers in determining public policy, as contemplated under the dual federalism model; choose interdependence through the instruments of cooperative federalism such as grants; or displace states and localities through coercive federalism.

Over the past 30 years, federal officials increasingly have resorted to a wide range of preemptions and mandates to carry out their policies. Frustrated with the carrot, federal officials who are focused on national goals and constituencies have frequently turned to these more coercive methods, notwithstanding their potential to cause greater intergovernmental conflict.[1] State officials are all too prone to engage in the same kind of unilateral mandates and preemptions in dealing with local governments. Structural fiscal imbalances at both federal and state levels may very well exacerbate these trends.

Preemptions in their various forms have been growing far faster than at any other time in our history. [2] As the chart below illustrates, preemptions have grown in recent decades in many program areas on the spending side, including environmental protection, transportation and criminal justice.



*The 1990-1991 rate was multiplied by 5 to estimate how many preemptions might be enacted during 1990-1999.

Source: U.S. Advisory Commision on Intergovernmental Relations, Federal Stautory Preemption of State and Local Authority: History, Inventory, and Issues (Washington, D.C., 1992), p.7.

In recent years, these tools have become extended to constrain, prescribe and even prohibit state and local actions on the revenue side as well. The income tax system has long depended on intergovernmental cooperation to streamline administration and reduce taxpayer burdens. Nearly all states with income taxes use the federal tax base as their starting points, providing significant simplification to taxpayers.

Nonetheless, recent tax actions at the federal level have resulted in unilateral changes to shared tax bases. Such changes force states to acquiesce and accept the consequences or decouple from the federal tax base. The 2001 federal tax cuts phasing out the federal estate tax knocked a $9 billion hole in state revenues, owing to the federal-state partnership in levying estate taxes. The state estate tax credit, which ensured taxpayers against double taxation, was permanently eliminated even though the federal estate tax itself was not. The states were faced with the unpalatable choice of either accepting federal tax policy decisions along with a major cut in revenues or continuing with their own estate tax policies at the expense of greater complexity and burden for their taxpayers.

Federal preemptions of their tax bases have also limited states' capacities to handle expanded responsibilities from federal mandates and policies. The sales tax has been eroded by the growth of remote internet and mail order sales – an area which the Supreme Court has ruled off limits to states unless Congress passes new legislation. This federal regime has not only had an impact on states, but has established an uneven playing field where businesses offering products through remote sales gain tax-free advantages over traditional brick-and-mortar retailers.

As the foregoing suggests, unilateral actions can create imbalances in any interdependent system. Unilateral actions risk overgrazing the "fiscal commons" -- the fixed resources available to each level of government as well as business entities and other taxpayers. In the case of federal or state governments, this unilateral behavior often takes shape by way of spending mandates (more resource demands on the commons) and revenue limitations (more fences). These actions have the effect of both limiting total state and local revenues as well as encumbering the use of those revenues for federally defined purposes. Imbalances can also result when governments separately impose tax burdens on the private economy without carefully considering their aggregate impact on economic efficiency and equity.

Intergovernmental Collaboration: A New Strategy for Fiscal Sustainability

The fiscal problems facing all levels of government in our system are daunting indeed, both for the short term and over the longer term. As they face up to these challenges, governments have several choices:

- **Go-it-alone** – each level of government develops approaches to deficits on its own. While easier to achieve politically, such approaches will fall short in their impact on the economy and on policy effectiveness. Solving the fiscal costs associated with health care is most efficiently accomplished through concerted action. Each government can strike its own deal but is at a disadvantage when dealing with a complex national industry. Similarly, extending the sales tax to the internet can only be addressed through concerted national action by states working collectively. Each state attempting to tax remote sales risks violating Supreme Court rulings as well as suffering from opportunistic actions of other states courting national businesses through lower taxes.

- **Fiscal off-loading** – federal, state or local governments can off-load their fiscal problems by passing them off to other governments in our system. The unfunded mandate requiring states to spend nearly $11 billion to change drivers licenses under the Real ID Act of 2005 is one example of how the federal government can abuse its constitutional supremacy to pass costs to other governments in our federal system. States use similar strategies when dealing with local governments. Similarly, state or local governments can abuse federal grant funds intended for specific purposes by using them to replace their own funds, undermining federal program goals.

- **Fiscal collaboration** - governments can join together in developing common, "win-win-win" solutions to common problems. Health care is one obvious example. The passage of legislation that yields real cost savings in the delivery of health care constitutes such an approach, with savings for all governments involved in financing health care.

A go-it-alone approach by each level of government will make necessary reforms that much harder. Unfunded mandates, inadequate cost-sharing and a general lack of regard for the effects of policy on other government entities have often resulted in higher costs as well as public confusion and skepticism about the effectiveness of government. State and local officials will have to deal with federally imposed costs and priorities against the backdrop of a more constrained revenue base.

In going it alone, state and local governments will also have increasing challenges in playing their time-honored role as policy innovators testing new approaches to major public policy challenges. Whether it be reining in health care costs or controlling carbon emissions, it is becoming increasingly difficult for states to regulate highly complex national economic sectors and problems on their own without support from other states and the federal government. For instance, Massachusetts, which blazed new paths in covering the uninsured on its own initiative, is finding that any serious effort to cut health care costs must involve Medicare, a federal program over which the state has no control.

Washington pays a price for going it alone as well. It gets substantial assistance from state and local partnerships in programs ranging from Medicaid to environmental protection, entailing shared resources and expertise. Unilateral federal actions jeopardize the state and local support and active partnership that are so essential to the successful implementation of nearly all federal domestic initiatives. The recent recession has reminded us that steep state and local budget cuts can also undermine those partnerships as well. Pressed by their own fiscal challenges, state and local governments are more tempted to use federal grants to replace their own funds rather than expand services – a result at odds with national policy goals.

When all governments in our federal system suffer from common maladies, joint solutions would be preferable. Through fiscal collaboration, governments can join together in developing win-win solutions. Dealing with health care costs, for example, is most efficiently accomplished through concerted action. Each government can strike its own deal but will be at a disadvantage when dealing with a complex national industry.

One example of how such a process of fiscal collaboration might produce win-win outcomes involves the consideration of a consumption tax, or a value added tax (VAT). The United States is the only major advanced nation without a national consumption tax. When compared with state sales taxes, a VAT has several advantages, including a national and international reach into the service economy and revenue potential that could go a long way toward filling fiscal gaps at all levels of government.

Such a tax has remained stymied, partly due to concerns over regressivity but also because of worries over its potential preemption of state sales taxes. Absent an intergovernmental partnership, the danger to the states from a national consumption tax is very real. A federal government desperate to solve its own billowing deficits could enact a consumption tax unilaterally that would threaten to undermine state sales taxes.

However, as Australia has shown, a national government can adopt such a tax with state and local governments sharing in the gains. States can piggyback on the expansive national consumption tax base, replacing their own declining sales taxes with a far more productive tax. An intergovernmental dialogue and a real policy-making partnership could lead to adoption of a consumption tax in this country that satisfies the fiscal interests of the entire public sector.

Another illustration of the potential for collaboration would involve reconsidering the roles of different levels of government in the financing and delivery of services in various policy areas. Trade-offs could rebalance responsibilities to better fit the unique capabilities and competencies of each level of government. Under this scenario, Washington might assume responsibility for programs that are national in scope and consequences while lower-level governments take control over programs with more local or state application.

Such an approach was offered to the states under the Reagan Administration; states were given the opportunity to have Medicaid federalized while responsibility for education, highways and welfare programs would be returned to the states. In retrospect, it appears that such a trade would have benefited the states and might have enabled the federal government to design a more cost-effective Medicaid program.

Other federal systems have shown that considerable progress can be made through intergovernmental negotiation and dialogue. While we engage in episodic partnerships such as the Recovery Act grants, we have no continuing forum for such dialogue in our system. The old Advisory Commission on Intergovernmental Relations was abolished in 1995 and nothing took its place.

Principles and Recommendations

As never before, intergovernmental cooperation is vital to enable governments at all levels to effectively cope with the long-term fiscal challenges stemming from changing economic and demographic forces. Ultimately, a process of fiscal collaboration stands the best chance of both dealing effectively with the structural deficits plaguing the entire nation now and in the future, and promoting public support for appropriate action.

The Council recommends that all governments in our system adopt certain principles to protect the fiscal commons and promote collaboration across governments. These would include the following principles:

- **Whole of government .** When new policies are adopted, their effects on governments as a whole should be considered. Unfunded mandates, inadequate cost-sharing, and a general lack of regard for or understanding of the effects of policy on other governmental entities have often resulted in higher costs imposed by one level of government on others as well as public confusion and skepticism about the effectiveness of government. In the area of tax policy, any long-term consideration of federal tax reform must provide for consultation and specific consideration of the interrelationships between our federal systems' three layers of tax systems in the midst of one of the most serious recessions in a century. Accountability requires each level of government to assume responsibility not only for the benefits of public policy but also for the costs across governments in our system.

- **Foresight.** Governments at all levels must consider the implications of their choices for the long term. Many of the policies driving deficits yield short-term benefits to current stakeholders at the expense of future generations of taxpayers who will have to pay escalating costs in a slower-growing economy. Taking action to resolve these fiscal imbalances will require today's decision-makers to adopt longer time horizons.
- **Fiscal precaution**. When alternative cost estimates for a program are given, the less optimistic estimate should be used. For decades, governments have used rosy scenarios that have overestimated revenues and underestimated costs. Consequently, deficits and debts are at an all-time high.
- **Reexamination.** A general reexamination of major policies and programs is urgently needed. More sustainable approaches should be developed in most critical public service areas, including pensions, health care, education, infrastructure, and energy supply and conservation. Policies in many of these areas have evolved incrementally and reflect yesterday's resources and priorities, not tomorrow's.

These principles are not self-executing. A "whole of government" approach must have an institutional framework if it is to become an important part of decision-making in our system. For such a process to work, state and local governments must be viewed as more than "just another interest group" – indeed, they must be considered vital partners in making government work for the 21st Century. At the present time, there is no formal process or institutional structure to promote the kind of collaboration we have in mind.

The Council recommends several steps to establish institutional foundations for collaboration across governments on our system:

- **Establishing an institution to serve as the champion for intergovernmental collaboration.** Such an institutional focal point should not only serve as a neutral convener of discussions among officials across levels of government but should have a highly competent staff to do the studies and analysis necessary to guide the collaboration process.
- **Broadening the Unfunded Mandates Reform Act of 1995**. The current Act at least forces some recognition that changes in federal law may have serious fiscal consequences for state and local governments. It requires CBO estimates of state and local cost impacts of proposed legislation and provides for members of Congress to raise a point of order against considering legislation with significant intergovernmental costs. It is time to extend the coverage of the Act's procedural protections to tax and grant-in-aid legislation that is estimated to have a significant intergovernmental fiscal impact.

- **Providing periodic opportunities for dialogue between the Virginia congressional delegation and Virginia's state and local officials.** The congressional delegation, the governor and local governments should collectively take the initiative to establish regular meetings focused on specific policy and budget issues vital to solving the fiscal challenges affecting us all.

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[1] See Paul L. Posner, The Politics of Unfunded Mandates: Whither Federalism? (Washington, D.C.: Georgetown University Press, 1998)

[2] See Joseph Zimmerman, Congressional Preemption (Albany, N.Y.: State University of New York Press, 2005)