The $52 Billion Surplus

What Washington Can Learn from States and Cities

Larry Mone

The talk in Washington is of $200 billion budget deficits as far as the eye can see. But the story in statehouses and city halls is of renewed fiscal health. In 1984, according to Commerce Department estimates, state and local governments posted a combined revenue surplus of $52 billion. And a recent Treasury Department study predicted that if current tax and spending policies were continued, states and localities could rack up a combined surplus of $86.5 billion by 1989.

Why is it that state and local officials can balance their budgets while the feds cannot? One reason is that states and localities are spared the fastest growing expenses in the federal budget—defense and Social Security. A more important explanation is that governors and mayors have begun to put their houses in order.

Beginning in the mid-1970s, for example, state and local governments moved to put their pension plans on a sounder actuarial basis, by setting aside funds that cannot be used to finance daily government operations. In 1984, contributions to state and local employee pension funds exceeded outlays by $42.5 billion. This is in sharp contrast to the federal civil service retirement systems which still run on a pay-as-you-go basis. In 1984, federal benefit payouts exceeded employee contributions by $16.2 billion, a bill picked up by the U.S. Treasury and added to the overall federal deficit.

The state and local pension surplus is partly a demographic phenomenon. Thanks to a hiring boom in state and local governments during the 1960s, the ratio of employees to retirees is higher than in the federal government. The surplus should decline in the late 1990s, as state and local employees start to retire in large numbers.

While pension funds account for most of the state and local surplus, state operating budgets (including rainy-day funds) also ran a combined surplus of $5.3 billion in 1984. Indeed the most important lesson that Washington can learn from city halls and statehouses is how to keep spending under control.

The boom days of state and local government are over. From 1949 to 1975, state and local expenditures nearly doubled as a percentage of GNP—from 7.8 percent to 15 percent. By 1983, they had fallen to 13 percent. This has come about through a combination of what John Shannon, of the Advisory Commission on Intergovernmental Relations has called the three R's—"tax revolt, reduction in federal aid, and recession."

The tax revolt, which started in 1978 with California's Proposition 13, limited the ability of states and localities to finance growth in government programs through tax increases. Between 1978 and 1980, 32 states cut their personal income or general sales tax.

At the same time, federal aid to states and localities also began to decline. From 1950 to 1978, federal grants rose from 11 percent of state and local receipts to 23 percent. By 1983, that figure had dropped to 18 percent. Federal grants no longer provided an incentive for increased spending on the state and local level.

Finally, the two recessions between 1978 and 1983, and the revenue shortfalls that resulted from them, induced greater fiscal conservatism on the part of the states.

Budgetbusters

These factors forced state and local governments to tighten their belts in a number of ways.

In New Jersey, a management study undertaken by private sector executives took a comprehensive look at inefficiencies in state government. Many of the recommendations of this mini-Grace Commission were implemented, including reducing the number of supervisory personnel in state agencies and reassigning them to "on-the-line" positions.

A full-scale effort to modernize and computerize state administration also brought in significant savings. Computerizing the welfare system allowed the state to collect a large number of child-support payments from delinquent fathers, saving the state over $15 million in welfare costs. Overall, New Jersey was able to reduce spending by $100 million out of a total budget of $6.8 billion in fiscal 1984.

In California, Governor George Deukmejian was able to achieve even more substantial reductions in spending through the use of the line-item veto. By blue-penciling hundreds of individual items in the state's budget, he shaved $1.2 billion off the $22 billion appropriated by the legislature for 1983.

Governor Deukmejian's vetoes struck down spending along a number of avenues. He made across-the-board reductions in merit salary hikes and inflation allowances for agency budgets. He also cut back on agencies whose functions could be more appropriately managed by the private sector, such as the California Energy Commission (the state's own version of the Department of Energy). Finally, Governor Deukmejian attacked the kinds of boondoggles that were funded for the benefit of special economic interests in the state—a good example being the $2 million "Mobile Pyrolizer," a machine designed to convert agricultural waste into fuel pellets. The only problem was that it took two 50-foot trailers to move it and cost $37 to produce a ton of fuel that could be sold for only $15.

LARRY MONE *is editor of the* Manhattan Report on Economic Policy.

These kinds of actions have had a real impact on the growth of state and local government. Between 1954 and 1978, the average annual increase of state and local expenditures per capita was 4.5 percent. From 1978 to 1983 per capita expenditures fell by a cumulative 6.5 percent.

For the same 1954–78 period, annual public employment growth in the state and local sector, adjusted for population, averaged three percent. In the post-Proposition 13 Era, 1978–83, state and local governments decreased public employment at an annual rate of one percent.

Era of Limits

The states have used both old and new devices to keep spending in check. Forty-nine of the 50 states have a constitutional or statutory requirement for a balanced budget. While these laws have been on the books for many years, the new fiscal conservatism produced by the tax revolt has increased their effectiveness. From fiscal 1978 to fiscal 1985, only 20 instances of deficits on the state level have been recorded—five of them in Vermont, the only state without a balanced budget requirement. This contrasts with the federal government, which has run deficits in 30 of the last 35 years.

The states are also experimenting with new devices to increase fiscal discipline. Taxation or expenditure limits (TELs), which limit the growth in state taxes and spending, have been adopted in 19 states. In 1980, Massachusetts passed Proposition 2½, establishing a constitutional property tax limit of 2.5 percent. The effects on taxes and spending have been dramatic. In 1980, the state and local revenue burden in Massachusetts totaled 16.3 percent of personal income. By 1983, it had dropped to 14.5 percent. Spending in 1980, which totaled 20.8 percent of personal income, also declined over the next three years to 17.1 percent. The reduction in taxes and spending have helped to produce an unprecedented boom in the Bay State's economy.

The severity of the 1982 recession made it difficult for states to pay their bills. One response was to raise taxes, and in 1983, 16 states raised their personal income tax while 12 raised their general sales tax. Property tax growth on the local level was also strong, with an 11 percent average increase nationwide.

These tax increases, however, explain only a part of the current financial resurgence of states and localities. Revenue forecasters miscalculated the strength of the 1983 economic recovery as much as they had underestimated the severity of the 1982 recession. In 1983, tax revenues exceeded budget estimates by over $9 billion. Indeed, the Treasury Department estimates that state and local revenues rose by $26.1 billion in 1983, and only $8.9 billion of this increase could be attributed to higher taxes. The remainder, $17.2 billion, was the fiscal dividend from economic growth.

The lesson from the states and localities is clear. Governments cannot tax their way out of deficits. Strict limits on taxes and spending, coupled with policies that promote economic growth, are the only sure prescription for fiscal health.

DISTRICT OF COLUMBIA

Why the Other Washington Doesn't Work

JOHN A. BARNES
AND JOHN H. FUND

Until 3 A.M. on election night, when Walter Mondale was finally declared the winner of his home state of Minnesota, the only Mondale island in the Reagan sea projected on network television maps was a flashing pinpoint of light halfway down the eastern seaboard—the defiantly Democratic stronghold of Washington, D.C.

Since receiving the right to vote for President in 1964, the District of Columbia has never come close to backing the Republican candidate. Washington, in fact, was the only electoral jurisdiction where the Democratic nominee actually fared better in 1984 than in 1980. This electoral behavior is only the most apparent of the many paradoxes that make the city of Washington wholly unlike the nation of which it is the capital.

While the rest of the country has a strong tradition of competition between the parties, Washington has no Republican Party worthy of mention. While the states are "sovereign" and their citizens take as a given their right to elect local officials, Washington, D.C. continues to be involved in a long, drawn-out debate over how much control it should have over its own affairs.

Further, as most residents know, there are really two Washingtons. There is the Washington celebrated daily in the pages of the *Washington Post* "Style" section: the city of marble monuments, the playground of national policymakers who live and shop in trendy Georgetown and gentrified Capitol Hill. It is overwhelmingly white and gives the city as a whole a higher per capita income than any state except oil-rich Alaska: $12,039.

The Other Washington is not physically far removed, but for most people in the first category, it may as well be light years. This is the Washington on the far bank of the Anacostia River and the public housing projects of Northeast and Southwest Washington. Seventy percent

JOHN A. BARNES, *national political reporter for syndicated columnists Rowland Evans and Robert Novak, used to cover District politics for the* Washington Times. JOHN H. FUND *is deputy editorial features editor for the* Wall Street Journal.