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A Brief History of State and Local Fiscal Policy

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State and local government is extremely important economically, both in the value of the public goods and services that it provides and as a determinant of economic activity. Its expenditures are roughly two-thirds of those of the federal government and about seven times the product of the U.S. automobile industry. Future changes in the size of state and local government will be significant to the course of the national economy and to policymakers at all levels of government. This brief examines the major state and local fiscal trends of the past in the hope that they can tell us something about the future.

It is impossible to rule out some future expansion of state and local government expenditures relative to GDP. However, it is difficult to imagine growth as vigorous as that through the mid-1970s.

The problem with using history as a guide is that different statistical measures yield different versions of history. All measures indicate that state and local government budgets grew rapidly relative to gross domestic product (GDP) between the end of World War II and the mid-1970s. After that, different measures lead to radically different conclusions. Census data show that state and local growth continued inexorably. National income accounts data suggest that relative growth halted abruptly in the mid-1970s.

Receipts as measured by the national income and product accounts (NIPA) peaked in 1977 at 14.0 percent of the GDP and have fluctuated slightly below that level ever since.[2] In 1997, they were at 13.5 percent of GDP. Local receipts as measured by the Census of Governments reached a peak of 17.7 percent of GDP in 1977, hesitated briefly until 1982, and then began a more or less steady climb to 19.7 percent of GDP in 1994, the latest year for which Census data are available. Chart 1 compares the two series.

Measurement Issues

Receipts measured by the Census are higher than the receipts shown in NIPA, since Census data include gross interest receipts; gross receipts from state and local enterprises, such as liquor stores, lotteries, and utilities; and receipts from sales of goods and services, such as hospital care and higher education. These gross flows have been rising relative to GDP in recent years. NIPA counts only the net receipts of state and local enterprises, net purchases of goods and services, and net interest payments. These are entered on the expenditure side of the budget as net positive or negative numbers. There are a number of other conceptual differences between the Census and NIPA, but none are significant in explaining the growing divergence between the two series since the mid-1970s.

Box 1 explores the differences between the two series in more detail. While no single measure tells the whole story, NIPA data seem to provide a better indicator of the economic importance of state and local government. NIPA's main flaw is that it regards the net proceeds of state enterprises and sales of services as negative expenditures. Hence, if net lottery proceeds grow, NIPA expenditure data make it appear that state and local government expenditures are shrinking.

However, this flaw is not very important quantitatively. If the surpluses of state and local government enterprises were removed from the expenditures and added to receipts, both state and local expenditures and receipts would still appear to have been roughly constant relative to GDP since the mid-1970s. Between 1977 and 1996, net enterprise surpluses rose by less than 0.2 percent of GDP, as growing surpluses from lotteries and utilities were offset by growing losses on mass transit.

The growth patterns indicated by NIPA data are also buttressed by employment data. In 1952, state and local employment constituted only 8.6 percent of total nonfarm payroll employment. By 1977, the state and local share of employment had grown to 15 percent. In 1997, it was 13.7 percent.

Although NIPA data may provide a better indicator than Census data of the economic importance of state and local government, gross revenue may be a better indicator of state and local revenue capacity, because small changes in fees and charges can add significantly to net revenues. Between 1970 and 1995, charges and miscellaneous revenue as a percentage of state and local government's revenue rose from 20.3 percent to 29.7 percent, as states and localities adapted to hostility toward the property tax.

Composition of State and Local Spending

Total state and local spending closely parallels receipts. This is not surprising—almost all states operate under a constitutional or legislated balanced budget rule.

State and local spending grew rapidly from the early 1950s to the mid-1970s. Total spending was about 7 percent of GDP in 1953 and peaked in 1975 at 14.8 percent. Much of the growth immediately after the early 1950s was making up for the deprivation of World War II and the Korean War. After 1975, spending declined

Chart 1
State and Local Government Receipts as a Percentage of Fiscal Year GDP: Census versus NIPA Data

Source: Census data are from NIPA table 3.19 (published and unpublished figures), supplemented by Series Y 652-670 in *Historical Statistics: Colonial Times to 1970, Part 2*, U.S. Department of Commerce, Bureau of the Census. NIPA data are from tables 3.19 and 9.4 (published and unpublished figures). GDP data are from NIPA table 1 (published and unpublished figures)

Note: Census data are recorded by fiscal years. Most, but not all, states' fiscal years end on June 30. Therefore GDP and NIPA calendar year data were adjusted by averaging the third quarter of the preceding calendar year through the second quarter of the following year.

slightly to 12.3 percent of GDP in 1984, but it rose to 14.3 percent by 1996.

Education is by far the most important component of state and local spending. It was slightly greater than 30 percent of total spending in the early 1950s, rose to over 40 percent in the late 1960s, and is now about 35 percent. It contributed disproportionately to the growth of total state and local government in the 1952–75 period, accounting for 46 percent of the increased share of GDP, due to the need to educate the baby boomers; chart 2 shows the close association of school enrollment with education spending over the decades. The subsequent stabilization of school enrollment helps explain the stability of state and local spending since 1975, since the baby boom was followed by a baby trough.

As shown in table 1, the "Income Support, Social Security, and Welfare" category was another major contributor to state and local government growth in the earlier period. The growth in this category occurred mainly in the 1965–75 period and was almost entirely due to the creation of the Medicaid program in 1965. The growth in Medicaid continued at a fairly rapid rate until 1989. From 1989 to 1994, Medicaid grew explosively. The 1989–94 surge occurred for a number of reasons: Legislation and court cases increased the number of eligibles and raised reimbursement rates; the recession of 1990–91 also added to the number of eligibles; the spread of AIDS added to costs; and states learned to manipulate the federal grant system.[3] Since 1994, Medicaid has remained fairly level relative to GDP.

Education and Medicaid expenditures accounted for almost 60 percent of the growth in the state and local share of GDP from 1952 to 1975. The education share declined from 1975 to 1984, which helps explain the slight decline in the share of total spending over that period. The Medicaid surge explains much of the increase in the share of total spending after 1984.

The rest of the growth between 1952 and 1975 is explained by a variety of factors. Almost all functions of government grew somewhat, although none grew as much as education and Medicaid. Table 1 shows the composition of spending in 1952, 1975, and 1996.

Box 1
More on Measurement Issues

Ideally, it would be possible to measure the true economic costs imposed by state and local activities, estimating the effects of all state and local activities, including regulation, on the amount and distribution of economic resources available to the rest of the economy. This is not feasible given the current state of economic knowledge.[1]

As a practical matter, the best alternative is to use spending or receipts relative to GDP. These numbers can be considered indices of governmental economic power; they are crude, especially in the short run, but may be more informative when used to explore longer-term trends.

But do Census or NIPA budget numbers provide the most meaningful indicators of state and local growth? Both series provide useful information. Apart from grants, which are included on the receipts side in both series, two types of transactions can be distinguished. In one, the government uses its sovereign power to extract involuntary payments from its residents. These are usually known as taxes but can include certain user fees. NIPA considers these involuntary payments receipts. In the other, the government is selling a good or a service in a business-like activity. The transaction is voluntary in that the person gets a clearly defined product, e.g., electricity or a lottery ticket, for his or her payment. This type of transaction is included in Census receipts.[2]

The profit extracted by publicly owned enterprises may seem more like taxes, especially if the state or local government has a monopoly in the provision of a good or service. NIPA's treatment of profit is somewhat counterintuitive, since NIPA considers profit a negative expenditure rather than a receipt.[3] Thus, if a state-owned utility raises prices and increases its monopoly profits, the profit shows up as a reduction in the level of spending relative to GDP and an apparent decline in the economic power of the state.

NIPA may give a better view of the tax burden imposed by state and local government, while the Census may provide a better look at the total value of all state and local financial transactions. But for reasons described below, NIPA probably provides a better indicator of trends in the relative economic power of state and local governments in the postwar period.

Between 1977 and 1994, receipts as measured by the Census grew by 2.1 percent of GDP. During the same period, receipts as measured by NIPA fell by 0.3 percent of GDP. The grossing up of interest accounted for about one-third of the total difference of 2.4 percent. Collecting interest with one hand on investments such as state pension funds while paying out interest on state debt with another hand is unlikely to have much impact on the economy. Consequently, it is appropriate to consider interest on a net basis, as NIPA does.

The gross receipts of state enterprises have risen in part because of the growth of lotteries, which involve large gross flows relative to the net contribution to state and local treasuries. Appropriately, NIPA measures their net contribution. The gross receipts of other state enterprises, which may be more indicative of the economic power of government, do not account for a significant portion of the divergence between the two series.

Gross sales, e.g., tuition and hospital fees, account for about one-third of the different growth patterns of the two series. In setting such fees, states and localities are exercising economic power and extracting resources from the public. But citizens would be paying similar amounts to private providers if government did not intervene in these areas, so there is less disruption in the flow of economic resources than if the same amount of resources were raised by taxes and used to pay for a good or service not provided by private markets. On balance, it is not clear whether gross or net flows are a better indicator in this category, but since net flows seem a better indicator in all other categories, NIPA data are used throughout the body of the analysis.

1. Herbert Stein. 1989. *Governing the $5 Trillion Economy*. New York: Oxford University Press.
2. The line between a tax and a voluntary transaction often becomes murky. One might say that a person voluntarily buys a car license in order to drive on the road, but the linkage between the service provided and the fee is weak, since the fee does not depend on the amount driven. NIPA records fees as taxes.
3. Although this seems peculiar, it would be difficult to consider surpluses of government enterprises taxes within the current NIPA structure. Surpluses and indirect taxes are deducted from the value of GDP in order to compute national and, ultimately, personal income because they create a wedge between the value of GDP and the incomes paid to wage earners and investors—they are extracted before income is paid. Direct taxes are paid out of wages and other types of personal income created by the production process.

Composition of State and Local Receipts

Between 1952 and 1976, state and local receipts rose by 7 percent of GDP. Growth in grants was the most important component of the increase, accounting for 38 percent of the total. The most important components of the grant increase were related to education, training, employment, and social services. Trends in total grants, mainly driven by education grants, followed the birthrate with a lag. The baby boomers helped to create a peak in the late 1970s. Grants then fell with the baby dearth until the early 1980s. Since that time, education grants have stabilized relative to GDP. Transportation grants increased in the late 1950s before leveling off, paralleling the importance of construction expenditures on the interstate highway system. Health grants increased significantly with the beginning of Medicaid in 1965 and leveled off after 1976. They again grew rapidly with the dramatic growth of Medicaid spending in the late 1980s and early 1990s.

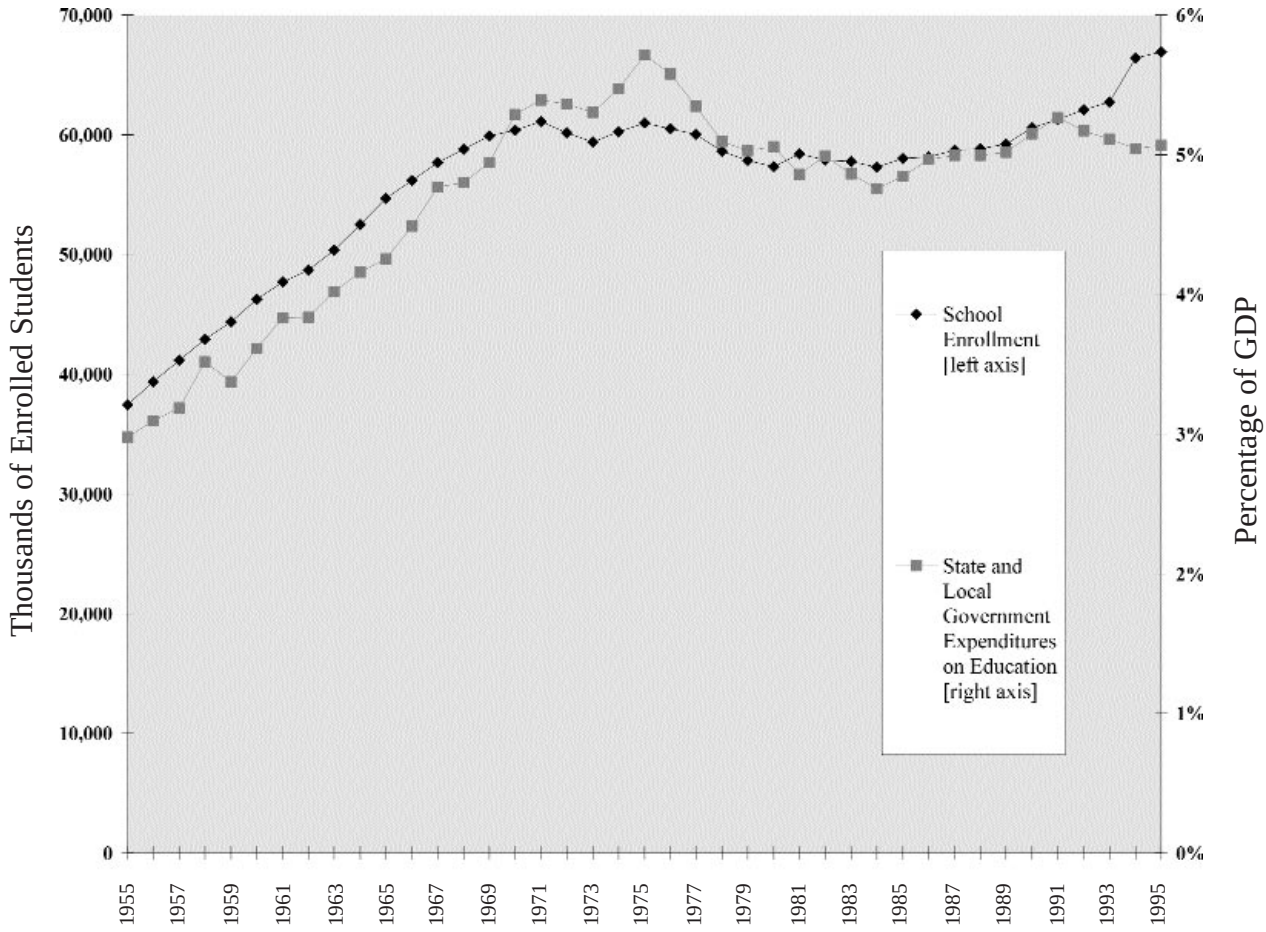
Another important component of the relative growth of receipts involved increases in indirect taxes and nontax accruals. The growth of this component primarily reflected increases in sales and excise taxes, accounting for 31 percent of the increase in total revenues. Increases in personal income taxes accounted for another 19 percent. Thus, almost 90 percent of the increase in receipts relative to GDP was due to three factors: grants, indirect taxes, and personal income taxes. Interestingly, property taxes, which are included in the indirect tax category, peaked nationally as a share of GDP in 1971, long before they became the object of the tax revolt in California. This suggests that in most areas explicit tax decreases or lags in assessments prevented property taxes from rising rapidly with the inflation of property values in the late 1970s. Property taxes have been remarkably stable since their small downward step in the late 1970s, hovering between 2.5 and 2.8 percent of GDP.

Implications for the Future

The vast expansion of state and local government in the 30 years following World War II coincided with a period of great economic prosperity in the United States, although the expansion of state and local spending outlasted the rapid economic growth of the 1960s and continued into the economically troubled early 1970s.

We are again enjoying a period of great prosperity. Will the relative expansion of state and local governments resume? The trends of the past suggest some possibilities about the future role of state and local governments.

Chart 2
School Enrollment for Those Ages 3–34 Relative to State and Local Government Expenditures on Education, 1955–1995



Source: U.S. Bureau of Census. Table A-1, *School Enrollment of Persons 3 to 34 Years Old, by Level and Control of School, Race, and Hispanic Origin: October 1955 to 1995* (for enrollment data); and NIPA table 3.17 in *Survey of Current Businesses*, October 1997, 77(10) (for expenditure data).

Reviewing the history of the previous expansion shows that some of the early growth simply made up for a lack of spending during World War II and the Korean War. Demographics also played a significant role in the growth of state and local governments, since birthrates drove education expenditures, albeit with a time lag. Although the echo of the baby boomers has imposed some pressures in recent years, these difficulties are minor compared with those faced earlier, and nothing in recent birth trends or immigration levels suggests serious future fiscal problems related to education.[4]

The other major driver of state and local growth was Medicaid, a key Great Society program. The Great Society probably would not have seemed affordable had it not been for the prosperity of the 1960s. Will the prosperity of the late 1990s usher in new entitlements that will be partially financed by states? President Bill Clinton has declared that "the era of big government is over," and fiscal conservatives clearly control the Senate and, more tenuously, the House. Yet the federal government recently created the Children's Health Insurance Program (CHIP), which is managed and partially financed by the states. Although the federal government will pay only $24 billion in block grants over five years, the program could easily be expanded. Child care might also receive more resources, though neither child care nor CHIP seem likely to become entitlements.

It is impossible to rule out some future expansion of state and local government expenditures relative to GDP. However, it is difficult to imagine growth as vigorous as that through the mid-1970s. There is no demographic driver pushing education costs, and the evidence on Medicaid suggests that cost growth under current law will be muted.[5] Although new social programs may be invented, the memories of the excesses of the Great Society are sufficiently vivid to encourage restraint.

The federal government has also become more sensitive about using mandates to impose costs on state and local government. A new law subjects mandates to points of order unless they are funded by the federal government. It is too early to judge the law's effectiveness, but the law is one more symbol of restraint, indicating that any future growth in state and local spending will be subdued.

Summary and Conclusions

The majority of the rapid growth of state and local spending between the early 1950s and the mid-1970s can be explained by two factors: the need to educate the baby boomers and the creation of Medicaid. The slowdown since the mid-1970s is explained largely by the baby trough that followed the baby boom.

Table 1
State and local Government Expenditures by Function

Function	Percentage of Total Expenditures			Percentage of GDP		
	1952	1975	1996	1952	1975	1996
Central Executive, Legislative, and Judicial Activities	5.78%	4.98%	6.03%	0.44%	0.74%	0.86%
Civilian Safety	7.31	7.24	9.88	0.56	1.07	1.42
Education	31.77	38.64	35.27	2.43	5.71	5.05
Health and Hospitals	7.52	5.29	3.17	0.57	0.78	0.45
Housing and Community Services	6.43	3.74	2.46	0.49	0.55	0.35
Income Support, Social Security, and Welfare	12.37	15.39	22.77	0.95	2.28	3.26
Medical care	0.42	5.90	14.96	0.03	0.87	2.14
Welfare and social services	9.94	7.92	6.88	0.76	1.17	0.99
Other income support	2.01	1.56	0.93	0.15	0.23	0.13
Transportation	20.59	13.78	11.87	1.57	2.04	1.70
Other*	8.22	10.94	8.56	0.63	1.62	1.23
Total	100.00	100.00	100.00	7.64	14.79	14.32

* *"Other"* consists of agriculture; commercial activities; economic development, regulation, and services; energy; labor training and services; natural resources; net interest paid; recreational and cultural activities; veterans' benefits and services; and other and unallocatable expenditures.

Source: NIPA, table 3.17 in *Survey of Current Business*; October 1997, 77(10), supplemented by unpublished data from the same table.

The varying fiscal pressures created by education and Medicaid were cushioned by federal grants. Had it not been for the rise of Medicaid, grants from the federal government would now be a much smaller share of GDP than in the 1970s (see chart 3). Falling education and training grants account for a major part of the decline, but transportation and community development grants also declined in the 1980s as the federal government wrestled with its budget deficit. Outside of Medicaid, states and localities have had to become more self-reliant.

The mid-1970s break in spending growth was an important macroeconomic event. Prior to that time, the strong underlying growth in state and local spending tended to mute recessions and enhance booms. Since the mid-1970s, state and local government spending has become a more symmetrical destabilizing force, as recessions create a need for tax increases and spending cuts aimed at satisfying balanced budget requirements and booms do the reverse.

Although state and local government may resume its relative growth in the future, all indications suggest that the growth will be subdued. We could see more spending on children's health and child care and further expansion of Medicaid, but without a demographic shift to push up education expenditures or the creation of a large entitlement program, change should not be extensive. The era of big government may not quite be over, but government is unlikely to grow rapidly in the foreseeable future.

Notes

1. The author would like to thank John Shannon, Donald Peters, and Alan Weil for useful comments, but he does not implicate them in any of the conclusions of the analysis.

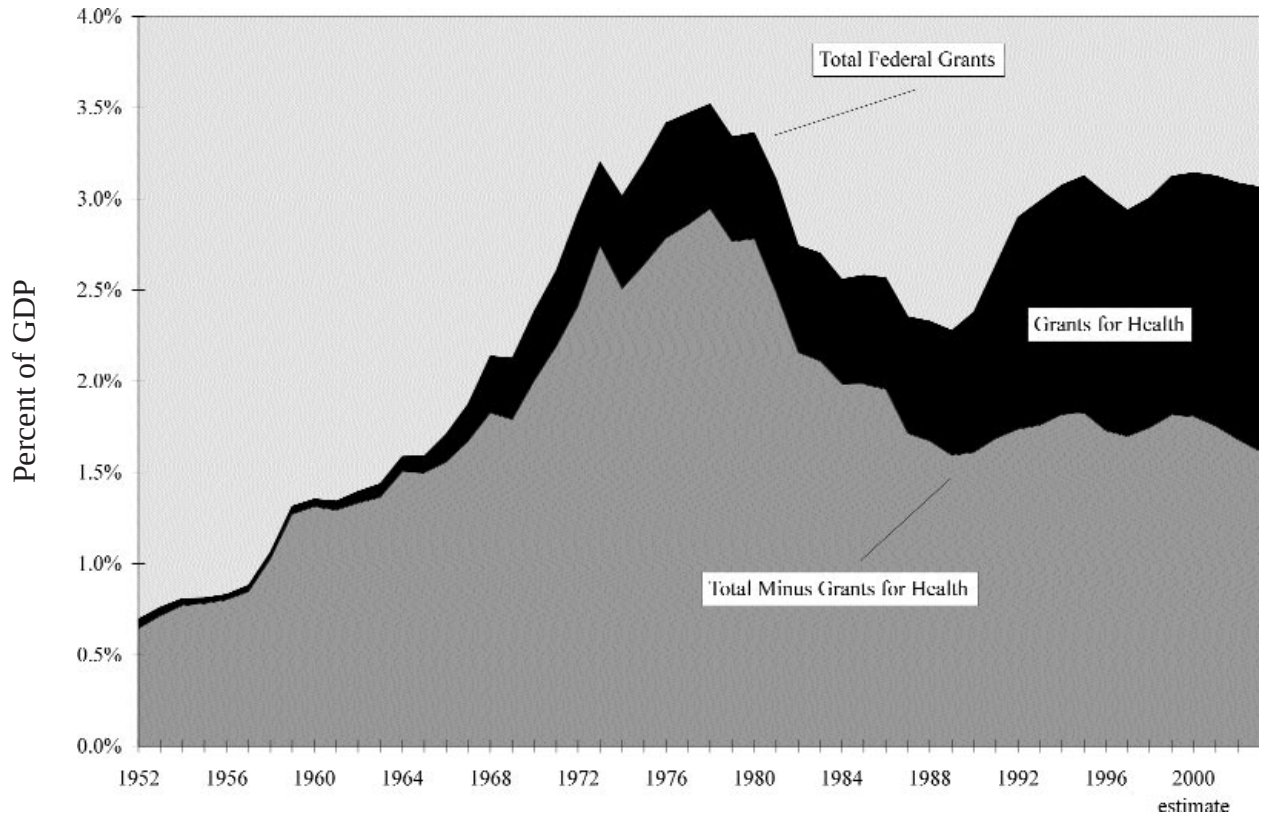
2. State and local budget data are provided by the Census for fiscal years. They are divided by GDP for the four quarters ending June 30. Many but not all state and local fiscal years end on that date. Most NIPA data in this article are provided for calendar years and divided by calendar year GDP, except when compared to Census data, as in chart 1, in which case they are converted to fiscal years.

3. Teresa A. Coughlin, Leighton Ku, and John Holahan. 1994. *Medicaid since 1980: Costs, Coverage, and the Shifting Alliance between the Federal Government and the States.* Washington, DC: The Urban Institute Press; and Martcia Wade, Kathleen Adams, and Stacy Berg. 1994. *Analysis of the Recent Expansions in Medicaid Costs.* Washington, DC: The Urban Institute Press.

4. Dale Russakoff. 1998. "The 'Millennium Generation' Is Making Its Mark." *The Washington Post,* June 29, page A1. The article implies that the number of children is growing rapidly, largely because of immigration and the high birthrates in immigrant families. However, data supplied with the article suggest growth rates significantly less than 1 percent per year.

5. John Holahan and David Liska. 1997. "Reassessing the Outlook for Medicaid Spending Growth." *Assessing the New Federalism Policy Brief,* Series A, No. A-6, March. Washington, DC: The Urban Institute Press.

Chart 3
Federal Outlays for Grants to State and Local Governments as a Percentage of GDP: Medicaid and the Growth of Grants for Health



Source: Office of Management and Budget (OMB). 1998. *Budget of the United States: Fiscal Year 1999, Historical Tables.* Table 12.2, pp. 205–210. Washington, DC: GPO.

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