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MEMOS TO NATIONAL LEADERS

SUBJECT: AMERICA'S INVISIBLE GOVERNMENTAL CRISIS: INTERGOVERNMENTAL RELATIONS IN A TIME OF TRANSITION AND UNCERTAINTY

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The American intergovernmental system was one of the great institutional inventions of the Country's founding fathers. It serves many purposes ranging from facilitating our democracy through the dispersal of political power, to enabling individuals in local communities to more carefully and strategically address the many problems that exist in a complex society. That this system has played a major role in facilitating the building and development of the American nation goes without saying. Nevertheless, this is a system that is currently in a state of crisis - in part because it has worked so effectively for so long that often little or no attention is paid to it. This is highly unfortunate since the American governmental system is an interlocking one in which the actions of each level impact upon each of the others.

Today, more than ever, the intergovernmental system faces multiple highly complex challenges. Many of these challenges are driven by fiscal factors, but not all of them. Political and administrative conflict, exacerbated by a highly polarized political environment, has dramatically lessened the capacity of the system for cooperation at a time when collaboration is desperately needed. While many proposals are being put forward to address the problems faced at the federal, state and local levels of government, rarely do those proposals recognize that they are highly dependent for successful implementation on circumstances that are often predetermined at another level of government.

To help the next Administration, the next Congress and our state and local governmental leaders to more effectively address these issues, a group of four individuals with long experience both studying and participating in the American governmental system has prepared the attached memo. These individuals have held senior positions in local, national and state government and have also written extensively about intergovernmental relations in the United States and abroad. The memo on "America's Invisible Intergovernmental Crisis" provides important recommendations for reinvigorating the American intergovernmental system and the nation itself. Most significant in this regard are the calls for a joint federal, state and local reassessment of the nation's tax policies with a focus upon the introduction of a shared consumption tax and the need for the establishment of an institutional mechanism to facilitate intergovernmental collaboration.

MEMO #1: AMERICA'S INVISIBLE GOVERNMENTAL CRISIS: INTERGOVERNMENTAL RELATIONS IN A TIME OF TRANSITION AND UNCERTAINTY

Summary: *It is now widely recognized that at all three levels of government in the United States there is a mismatch between available revenues and citizens' demands for public services. Almost every study of this situation, whether at the national, state or local level, suggests the problems will inevitably become far worse in the absence of significant action. What is often not recognized, however, is that in many instances these situations are inextricably interrelated across all three levels of government. The fact is that the country faces an intergovernmental crisis and that if it does not address its fiscal problems from an intergovernmental perspective, it will not be able to address them successfully. In order to strengthen the federal system emerging needs for public services and public deficits must be addressed; intergovernmental tax reform should be undertaken in a collaborative manner; a means to an institutional framework for the improvement of intergovernmental policy must be initiated; and, much work must be done to rationalize that system.*

The evidence of the serious problems, indeed the crisis, of the American intergovernmental system is everywhere. Whether it is Senator Lamar Alexander recently calling, in a Wall Street Journal op-ed piece, for a grand exchange by the federal and state governments of responsibilities for education and health policy as a means to help solve critical state financial problems or news stories reporting municipal bankruptcies and that state and local governments have laid off over 700,000 employees (teachers, police, fire people, etc.) during the past two years, the evidence of the problems are all around us. Serious research studies point to equally serious long term issues. The Government Accountability Office (GAO) has found that over the past few years state and local revenues have shrunk to the point that federal grants represent a bigger part of state and local government revenues than any single self-raised tax revenue source and that those same governments are, unless policies change significantly, on a course in which, 50 years from now, health care expenditures will have become almost 50% of their budgets, as non-health care expenditures continue to decline dramatically.

Nevertheless, it took the Supreme Court in its highly publicized immigration and health care decisions of a few weeks ago to really remind us of the fact that no individual governmental institution or set of institutional relationships is more important to public policy making and government service delivery for the American people than our complex intergovernmental system. Despite this reality, that system, in spite of how frequently it shapes and influences policy making and its outcome, is the most ignored and least paid attention to governmental element in contemporary American political life. Rarely does it receive serious attention from government officials. Almost never is it given major attention by the media and those few governmental institutions that have focused upon it have, or are in the process of, disappearing or becoming irrelevant.

The Intergovernmental System Faces Multiple Challenges

The administrative, political and fiscal challenges that confront the contemporary intergovernmental system are numerous. The administrative challenges confronting it involve both short and long term issues. In the short term, this includes coping administratively with the increased service demands of a weak economy and the dramatic personnel reductions which many state and local governments have been forced to implement. Longer term is the challenge of attracting and retaining a qualified public sector workforce in an aging society. This is even more exacerbated by the numerous, and sometimes severe, reductions in salary, health and pension benefits which in many instances have served to demoralize state and local employees. From a federal systems perspective, the long term decline of institutions with expertise on intergovernmental issues has diminished the system's capacity for sound decision making on intergovernmental policy and management issues.

From a political perspective, today's very high levels of partisan polarization is crippling the nation’s ability to deal with budget, economic, and social issues—or meet basic policy responsibilities in some cases. Increased political polarization is also affecting state level policy making. The hope that states might survive as oases of pragmatic governance in a polarized era is diminishing. Rather, polarization is increasingly affecting relations among all levels of government in health care, environmental policy and many other areas, thus making policy making and its implementation much more difficult.

Fiscally, all levels of government are facing huge long and short term fiscal challenges. At the national level, pressures on nondefense discretionary spending are intensifying with the adoption of budget caps and likely sequestration. Future deficit reduction efforts are likely to increase these budgetary pressures even further, extending cutbacks to major entitlement programs like Medicaid. This will have significant consequences for federal grants in aid to state and local governments.

States, meanwhile, are still digging out of the deep fiscal hole caused by the Great Recession. While some state budget outlooks are improving, most are not yet back to pre-recession levels. Even more importantly, the long term fiscal outlook for state revenue systems is clouded by the shrinking base of state sales tax systems, as online sales and the service sector continue to grow, as well as growing state tax competition in an increasingly globalized economy. On the expenditure side, GAO's analysis of the long term sustainability of state and local finances indicates that these governments, like the federal government, are on an unsustainable fiscal path which will necessitate significant policy changes.

Finally, local revenue budgets continue to reflect the housing recession’s impact on revenues. Because of lags in the assessment system, local property tax revenues are still declining and municipal bankruptcies are on the rise.

As they face up to these challenges, governments have several choices:

- **Go-it-alone** – each level of government pursues their own policies independently of other levels of government.

- **Fiscal offloading** – federal or state or local governments can off load their fiscal problems by passing them off to other governments in our system.

- **Institutional and Fiscal collaboration** – governments can join together in developing common, win-win-win solutions to common problems.

A go-it-alone approach by each level of government will make the hard fiscal choices that much harder. Federal tax cuts, for instance, materially affect the revenues available to the vast majority of states whose income taxes are linked to the federal tax code. The estate tax cut and phase out in 2001 caused a large revenue hole for the many states who had relied on a cooperative federal-state framework for decades to enforce the state portion of the estate tax. Conversely, state cuts in staff recently have affected such federal programs as disability determinations for social security which rely on states to help evaluate actions – a classic cooperative federalism program that is undermined by unilateral budget cuts.

Fiscal offloading includes the many unfunded and underfunded mandates and other shifts of costs to states and localities, as well as private sector and non-profit organizations, by the federal government. The Bush Administration's Real ID Act would have cost states $11 billion if they didn't fight back, and the new block grant proposals for Medicaid in Washington would constitute a massive cost shift to states unless they found ways to cut clients and payments to doctors.

Go it alone and fiscal offloading strategies reflect a general lack of regard for the effects of policy on other government entities, resulting in higher costs as well as public confusion and skepticism about the effectiveness of government. The effects on state and local officials have been underscored as they struggle to meet higher costs induced by the federal government at a time of historic budget cutbacks.

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 transportation policy, to environmental protection, entailing shared resources and expertise. Unilateral federal actions jeopardize the state and local support and active partnership that is so essential to the successful implementation of nearly all federal domestic initiatives.

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. 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.

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 consumption tax legislation that satisfies the fiscal interests of the entire public sector.

The Current Outlook Is Dim

Notwithstanding the payoff from collaboration, our collective capacity to work together in developing common policies across our federal system has sunk to record lows. At the federal level, the following is a list of the intergovernmental institutions that existed in both Congress and the White House that had the capacity to examine and resolve intergovernmental conflict in 1980:

- Advisory Commission on Intergovernmental Relations
- OMB Division of Federal Assistance
- House and Senate Subcommittees on Intergovernmental Relations
- GAO unit on intergovernmental relations
- CBO state and local cost estimates

Today, there are only two of these institutions left: GAO's intergovernmental unit and CBO's state and local cost projections unit. The White House continues to have intergovernmental liaison offices but these are widely acknowledged to be short term fire fighters set up to gain political support for the President from state and local officials.

State and local governments' capacity to work proactively with federal officials has also been weakened. Their interest groups in Washington are increasingly plagued by divisive polarization among their members that undermines their ability to even take positions on such measures as health reform and other important legislation affecting the federal system. This is in distinct contrast to other federal systems. Australia has quarterly meetings between national and state leaders, while Canada has semiannual conferences among these officials. While American Presidents, Governors and Mayors frequently talk about policies and ideas, rarely do they focus on the unglamorous role that our federal system plays in making this country work.

Comprehensive Federalism Reform Is Needed

The scale of both long and short term challenges has spurred some renewed interest in comprehensive policy reforms that will have significant impacts upon the federal system. Such reform initiatives can be explicitly focused on the intergovernmental system itself, as in the case of Alice Rivlin's proposal for a new sorting out of functional responsibilities and revenues between the national government and the states. Or, more commonly, may be implicit in various proposals for dramatic budgetary or tax reform. The latter includes proposals such as Rep. Paul Ryan's budget plan adopted by the U. S. House of Representatives, which, among other things, would convert Medicaid from an open ended matching grant into a capped federal block grant to the states. By capping federal obligations to what is currently the largest federal grant to state and local governments, and the third largest program in the federal budget and one of the largest in all state budgets, this plan would have major consequences for the financing and operation of the U.S. Federal system—consequences that are compounded by the plan's proposed long term cuts in federal discretionary spending.

By the same token, many proposals for comprehensive federal tax reform bear significant implications for state and local finance as well. Most such plans anticipate reducing or eliminating the federal deduction for state and local taxes as part of a larger strategy of broadening the federal tax base, and many anticipate major changes or elimination of the exclusion on interest on state and local bonds. Both these and other tax law changes would erode state and local governments' capacity to finance their own responsibilities in the federal system.

Politically, comprehensive reform proposals such as these tend to involve very high risks. All involve exceedingly complex issues of governmental finance, administrative capacity and political viability. But apart from their technical and administrative details, it is important to remember that they also involve core values in our political system. Many would significantly alter the intergovernmental system's capacity for assuring equal opportunities for all citizens, for encouraging state and local innovation and being responsive to the preferences of local constituencies.

First Steps in Reforms to Strengthen the Federal System

1. **Both emerging needs for public services and long term deficits must be addressed.** While the nation's intergovernmental crisis has many dimensions, at its heart is the absence of adequate revenue. For example, a recent OECD study points out that 30 years ago the US led the world in the percentage of 25-34 year olds possessing the equivalent of at least a two year degree. Most recent data shows that the US now lags behind 14 other countries in that measure of human resource capacity. Similarly, today 20 countries have higher High School graduation rates than the US. While this is occurring, states and localities in most parts of the country have been disinvesting in their educational systems and, in many cases, very significantly so.

While there are many explanatory factors, the most important one is the absence of adequate revenues. The Rockefeller Institute reports that state tax collections dropped by over 16% in just one quarter of 2009 and that by the end of 2010 they were barely at 2006 levels. Local governments are experiencing, as the Pew Center on the States has noted, the first time since 1980 the simultaneous decline of both state aid and property taxes. The increasingly long term recession has had parallel effects on federal revenues, which sunk to 15.1 percent of GDP – a level not seen since 1951 Since these declines have had significant impacts on both public services and debt, major tax reform is essential to address both emerging needs for public services as well as long term deficits at all levels of government.

2. **An intergovernmental tax reform initiative must be undertaken in a collaborative manner.** There is a need for a national tax reform initiative that should include federal, state and local governments. While recent federal budget commissions have called for federal tax reform to simplify the tax code and raise revenue, we worry that such an effort could lead to further erosion of fiscal capacity of state and local partners in our federal system. A national intergovernmental tax reform initiative would be far more effective in giving serious consideration to important new revenue systems such as a national consumption tax. As other OECD nations have shown, a national consumption tax along the lines of a value added tax could provide significant advantages for the national economy both in terms of additional revenues and savings incentives. However, given the states' substantial investment in sales taxation, only an intergovernmental tax reform process can gain the support of states that will be critical to implementing much needed reforms.

3. **Create an intergovernmental policy council.** The crisis of the federal system is not a short term one. The nature of the American governmental and political system guarantees that there will be continuing policy complexity and political conflict. This can and should not be ignored. It rather needs to be constantly monitored and, as necessary, proposals for adequate adjustment should be put forward in a timely and highly visible fashion.

Towards this end, the President should initiate an intergovernmental policy council that is adequately staffed and meets at regular (at least quarterly) intervals to review, assess and advise on initiatives designed to enhance the American intergovernmental system. It should be bipartisan in nature. Half of its members should be appointed from the federal level of government, in part by the President and in part by the party leaders of the two Houses of Congress.

The remaining half of its membership should consist half of governors and half of mayors or other elected local government officials. There should be two ex-officio non-voting members drawn from the executive directors of the seven major state and local governmental associations. The Council should assume as its task the ongoing assessment of the effectiveness of programs which involve federal government participation and are implemented by state and local governments. It should also address the strengths and weaknesses of the intergovernmental system, and, in particular, the adequacy of the resources to achieve desired policy outcomes.

4. **Immediately address reform in the grant system and personnel needs.** The Intergovernmental Policy Council should immediately begin to address the various issues that are central to the improvement of the effectiveness of the intergovernmental system. Towards that end, it should appoint working groups composed equally of national, state and local officials. Areas that should be addressed include:

- Grant reforms, such as program consolidation, improved grant management practice and block grants, to simplify an increasingly complex system characterized by over 900 separate categorical grants;

- Human resource policy reforms to help cope with the loss of experienced professionals in the public service and the effects of demographic change on service demands and public pension systems.