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Mildred E. Warner

Local Government Financial Capacity and the Growing Importance of State Aid

Since the 1970's, the Federal Government has been turning back funding and authority to State and local governments. Devolution has important implications for local government finances. As direct Federal funds to counties decline, local wealth and the redistributive role played by the States become more important in determining local capacity for spending. These developments are illustrated by the experience of counties in eight Mid-Atlantic and East North Central States.

The devolution, or decentralization, of funding and program authority from Federal to State and local governments has been an American political theme for about three decades. Decentralization appeals to notions of efficiency and local autonomy. However, in the current debate on devolution, few are asking whether local governments have the capacity to meet the new demands being placed upon them. To be effective, local governments must have both the managerial and financial capacity to assume wider responsibilities. This article examines the growing imporance of devolution with particular attention to the financial capacity of counties in eight Mid-Atlantic and East North Central States.

Local governments' ability to raise revenue is limited in large part by local well-being. Because macroeconomic forces favor some locations over others, local ability to raise revenue is unevenly distributed across the Nation. State and Federal aid, as political sources of revenue, can ameliorate or exacerbate unequal financial capacity across local governments. For less prosperous counties, the developmental and redistributive roles of government can be critical in regaining economic activity and building the local tax base. In fact, per capita costs of service provision may actually rise during times of fiscal distress. Publicly provided goods and services are critical components of local well-being and "poor governments," which spend less than some minimum relative to other counties, have been found to persist in poverty longer than or emerge from crisis slower than other counties (Reeder and Jansen). As direct Federal aid to localities declines in both relative and absolute terms, the redistributive nature of State aid (both State-generated aid and Federal block grants to States) becomes more critical.

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Three Waves of Devolution Since the 1970's

Since the 1970's, the United States has experimented with three different waves of devolution. The first, under Presidents Nixon and Ford in the 1970's, reflected a belief that the Federal Government could play a role in targeting support to people and places that were not prospering. Nixon shared President Johnson's commitment to providing Federal support for services but funneled this support through States and localities. He initiated general revenue sharing in 1973, bringing direct Federal aid to many localities for the first time. Local governments were also given freedom to allocate funds within a single, broad policy arena through the Comprehensive Employment and Training Act (CETA, 1973) and Community Development Block Grants (CDBG, 1974). Direct Federal aid to local governments reached its peak in 1978. This first wave can be described as "devolution with dollars."

The second wave came with the Reagan administration's "New Federalism," which brought a very different meaning to devolution—devolution of responsibility without funds, or "devolution without dollars." National attention shifted to performance of the economy as a whole. General economic reforms such as deregulation reduced Federal spending, and policies to lower inflation and interest rates were promoted with little regard to their differential impact on place. Responsibility for spatial inequality became the problem of States and localities. General revenue sharing to States ended in 1980 and was phased out for localities in 1986.

In the 1990's, relief from unfunded mandates became the battle cry of States and localities as they struggled to meet the challenges of devolution. In response, a third wave of devolution began, "devolution of authority." Some direct Federal programs have been cut back and converted into block grants over which States and localities will have wider discretion. Welfare reform represents the most far-reaching of these reforms, where Congress is shifting some authority over program standards to the States and reducing individual entitlements outright.

While the first wave of devolution acknowledged a major redistributive role for the Federal Government, the second and third waves of devolution are ceding this role to the States. However, interstate and interregional differences in welfare may not be addressed effectively at the State level. The Federal Government, because it draws its revenue from a wider array of tax instruments and from across all regions and economic sectors, is in a better position to finance equalizing investments than are the States (Peterson). Thus, we might expect increasing inequality among counties if redistributive funding is left to governments at the county and State levels. By looking at the response of State and local governments to the first two waves of devolution in the 1970's and 1980's, we may be alerted to key issues as our Nation continues the experiment with devolution in the 1990's.

Expenditures Higher in Metro Core and Nonadjacent Rural Areas

The fiscal needs of counties differ. Government expenditure is one reflection of fiscal need. After adjusting for inflation, per capita local government expenditures in the eight Mid-Atlantic and East North Central States increased by almost 17 percent during 1972-87 (from $1,029 in 1972 to $1,204 in 1987), partly as a result of expanded responsibilities due to devolution. Most of this increase was concentrated during 1982-87 ($1,073 in 1982 to $1,204 in 1987) when responsibilities, but not funds, were transferred to local governments. This was also a period of rapid economic growth following the severe recession in 1981-82. Since income is the key indicator of fiscal capacity, some of the spending increase is also attributable to increased fiscal capacity.

Population is the most common measure of fiscal need (one indicator used for most State and Federal general revenue sharing) but it does not reflect higher costs at both ends of the urban-rural spectrum. Reeder and Jansen argue that government costs are higher in metro areas due to concentrated population (and hence the need for more services) and in rural areas due to lack of economies of scale. Age of infrastructure, poverty level, and other demographic characteristics are also important determinants of need.

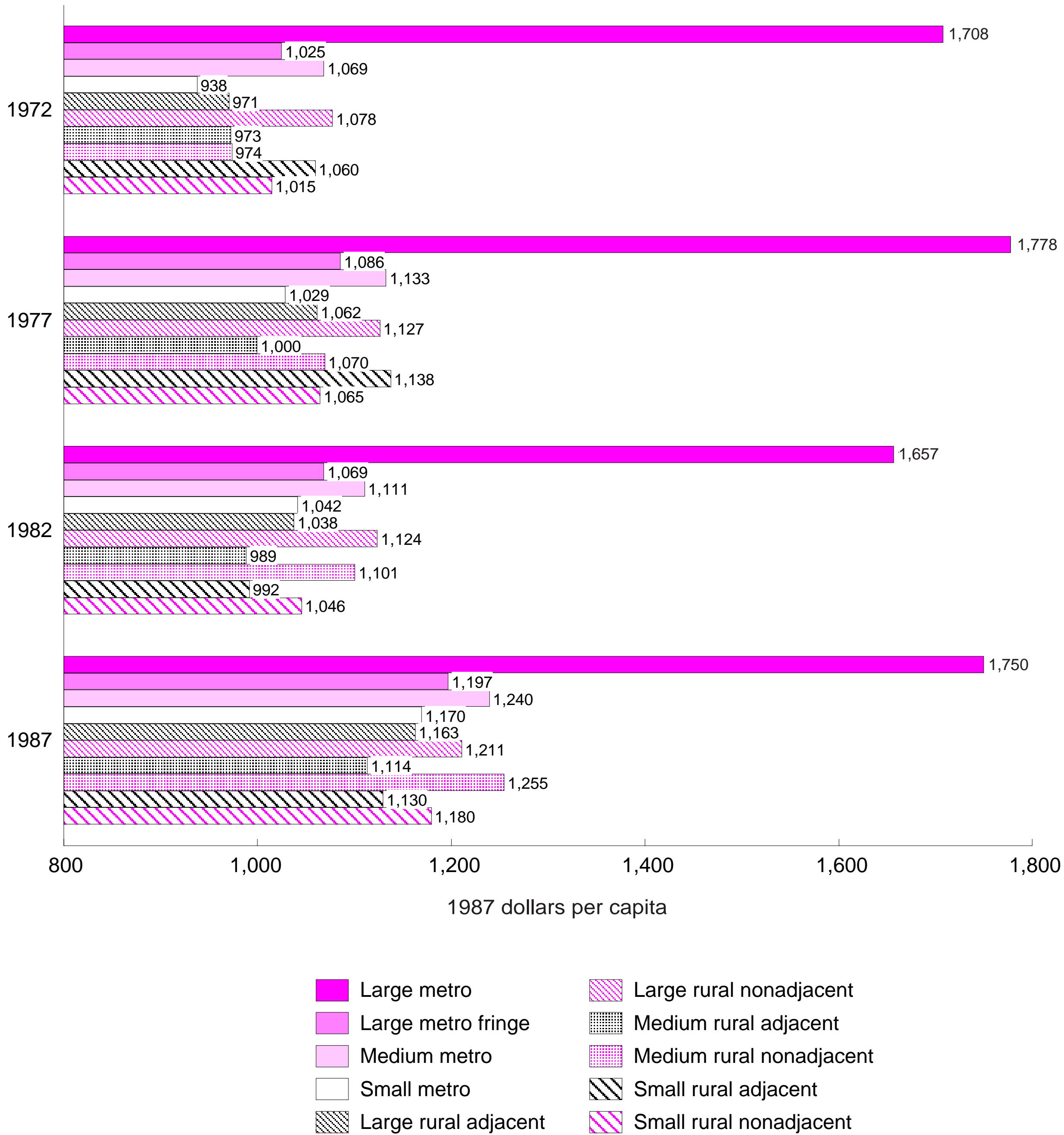
The most interesting aspect of local government expenditure is the dramatic differences in per capita spending levels across counties. Metro core counties (central cities) spent 70 percent more, on average, than their urban and rural counterparts in 1972. While other counties' spending increased in real terms relative to the metro core, there was still a 40-percent difference in mean local per capita expenditure by 1987. In 1982 and 1987, a clear pattern of higher expenditures for the nonadjacent rural counties emerges. This pattern lends credence to the notion of a cost curve with higher costs in both congested inner-city and sparsely populated rural areas (fig. 1).

Raising Revenue Is More Difficult in Metro Core and Nonadjacent Rural Counties

A county's tax burden can be better understood by looking at the amount of local effort it takes to obtain revenue. Local effort is usually measured as the ratio of locally raised revenue (taxes, user charges, and miscellaneous revenues) to local capacity (per capita income). In rural-urban comparisons, Reeder found that in rural areas with lower service levels, locally raised revenue accounts for a higher percentage of per capita income due to the high cost of providing essential services. Urban core counties have higher effort as well—a reflection of the higher service levels and higher taxes characteristic of large urban centers (fig. 2). Although effort dropped for nonadjacent rural areas in 1977 as rural counties gained access to Federal aid for the first time—through such programs as CDBG, general revenue sharing, and CETA—such relief was short-lived. By 1982, nonadjacent rural counties' effort rose dramatically again and, like the metro core counties, maintained a higher level than adjacent rural or small and medium urban counties.

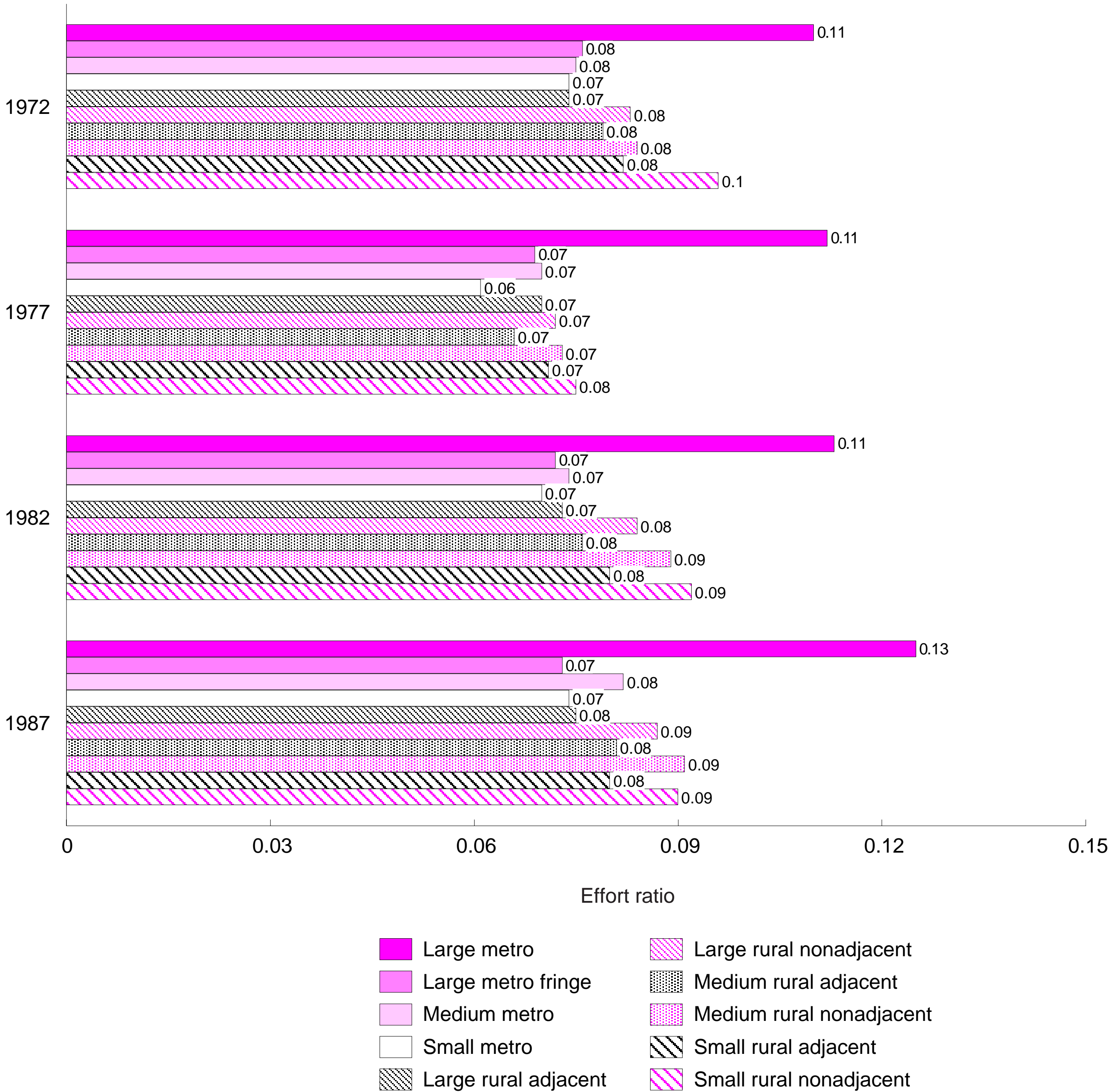
An important aspect of local effort is the increasing reliance on user fees and other nontax sources of revenue over time. The tax (property, sales, income) portion of locally raised revenue declined by almost 9 percent in real terms from 1972 to 1977, as State aid and Federal aid rose. Real per capita tax revenue continued to fall in 1982, despite a drop in Federal and State aid levels. By 1987,

Figure 1
Mean current expenditures by county type
Expenditures are higher for metro core and nonadjacent rural counties



Note: All government finance data deflated by GDP Implicit Price Deflator for State and Local Government Services. Data reflect 587 counties in Mid-Atlantic and East North Central States, 1987 = 100. Per capita income data deflated by Consumer Price Index, 1987 = 100.
Source: U.S. Census of Governments, 1972, 1977, 1982, and 1987.

Figure 2
Mean fiscal effort by county type
Fiscal effort is higher for metro core and nonadjacent rural counties



Note: Effort ratio = (per capita local taxes + per capita user charges and miscellaneous revenue) / per capita income. All government finance data deflated by GDP Implicit Price Deflator for State and Local Government Services, 1987 = 100. Per capita income data deflated by Consumer Price Index; 1987 = 100. Data reflect 587 counties in Mid-Atlantic and East North Central States.
Source: U.S. Census of Governments 1972, 1977, 1982, 1987.

taxes had risen again but were still below their 1972 levels in real terms. Locally raised revenue increased in real terms in the 1980's in large part because of dramatic growth in miscellaneous revenues and user fees (table 1).

Local Investment Capacity Depends on Economic and Political Forces

The ability of local governments to raise revenue comes from both economic and political sources. The economic capacity to raise revenues is determined by local economic well-being—commonly measured as per capita income. Per capita income represents the relative wealth of a place and hence the ability to raise local revenue. Local wealth derives primarily from two sources: the local labor market and transfer payments. Larger macroeconomic forces determine the structure of local labor market opportunity, and demographic features (especially the proportion of elderly and children) determine the level of pension and transfer income.

While real per capita incomes grew for all county types in the Mid-Atlantic and East North Central States during 1970-80, there was an important spatial dimension to that growth. While the rural-urban income spread narrowed from 1970 to 1980, it widened again between 1980 and 1990 (table 2). By 1990, mean per capita income had

Table 1

Components of locally raised revenue, mean dollars per capita, 1972-87

Taxes remain flat, while user fees rise

Year	Locally raised revenue	Taxes		Miscellaneous revenue and user fees	
	Dollars per capita	Dollars per capita	Percent of total	Dollars per capita	Percent of total
1972	738	559	76	179	24
1977	687	501	73	186	27
1982	757	487	64	270	36
1987	844	539	64	305	36

Note: Constant dollars, 1987=100. Government Finance Data deflated by Implicit Price Deflator for State and Local Government Services, 1987=100. Mid-Atlantic and East North Central States, N=587 counties.

Source: U.S. Census of Governments, 1972, 1977, 1982, 1987.

Table 2

Mean per capita income by county type, 1970-90

Per capita income rose for all counties from 1970 to 1980, but fell for all rural county types from 1980 to 1990

County type*	1970	1980	1990
		Dollars (1987=100)	
Large metro core	11,028	11,818	14,447
Large metro fringe	10,381	12,499	12,103
Medium metro	9480	10,935	11,456
Small metro	9139	10,926	10,536
Large rural adjacent	8829	10,404	10,223
Large rural nonadjacent	8083	9689	9374
Medium rural adjacent	8174	9861	9656
Medium rural nonadjacent	7653	9360	9049
Small rural adjacent	7576	9208	9078
Small rural nonadjacent	6373	8536	8350

Note: Income is deflated by the Consumer Price Index, 1987=100. Mid-Atlantic and East North Central States, N=587 counties.

*Number of counties in each category varies slightly over the time periods due to recalculation of the county typology for each decade: 1970, 1980, and 1990, respectively.

Source: U.S. Census of Population and Housing, 1970, 1980, and 1990.

increased dramatically for large metro core counties and significantly for medium metro counties but had fallen for all other county types. Variation within county types increased for all except the rural counties, and this variation was especially dramatic for large metro core counties, suggesting significant differences in fate due to economic restructuring for large cities across the eight-State region.

Local governments can do little to increase economic capacity since local economic well-being is primarily determined by broader macroeconomic and demographic forces. Thus, we must look to political sources to equalize capacity for investment across counties. Political capacity reflects the will to tax and spend. It includes local effort (willingness to tax oneself) as well as State and Federal redistributive aid. We already see higher effort levels among large metro core and nonadjacent rural counties. However, local political capacity is constrained by competition among localities; firms and residents will move to lower cost jurisdictions, everything else being equal (Peterson). Thus, an equalizing role is left primarily to Federal and State governments.

Redistributive Aid Depends on State and Federal Sources

A common rationale for intergovernmental aid is to equalize the burden of providing standard-quality public services. Fiscal disadvantage arises from both below-average capacity to raise revenues and above-average costs of providing service quality (Ladd and Yinger). Rural areas have both of these disadvantages. Local fiscal capacity, effort, and need all figure into the rationale for intergovernmental aid.

The importance of economic capacity is reflected in table 3, where we see that local investment capacity is primarily a function of locally raised revenue. Own-source (locally raised) revenue is the most significant component of total local revenue across all county types and all years. State aid is next in importance, hovering around 38 percent of the total. Federal aid is interesting because of its extreme volatility and its small magnitude relative to other sources of revenue. Most Federal aid—such as Social Security and Medicaid—goes directly to individuals: thus, direct per capita aid to places (the variable measured here) is relatively small. Some Federal aid to localities passes through States first as block grants. This aid is counted in the State aid total because decisions about how to redistribute the funds are made at the State level.

To equalize capacity and service quality across places, State and Federal aid to local governments is key. During the first wave of devolution (1972-77), direct Federal aid to local governments rose dramatically for all county types, but has been falling steadily (in real terms) since. State aid tracked Federal aid, rising in 1977 and falling in 1982 (table 3). Although mean Federal aid continued to fall in 1987, State aid rose again, suggesting an increasingly important role played by States during the Reagan years. Both Federal and State aid are disproportionately distributed to metro core counties. Throughout 1972-87, metro core counties received roughly double the Federal aid and 50 percent more State aid per capita than other counties. Nonadjacent rural counties also received more Federal aid, but not significantly more State aid. Large metro fringe counties received the lowest per capita State aid of any of the county types (figs. 3 and 4).

State Policy a Critical Determinant of Local Economic Health

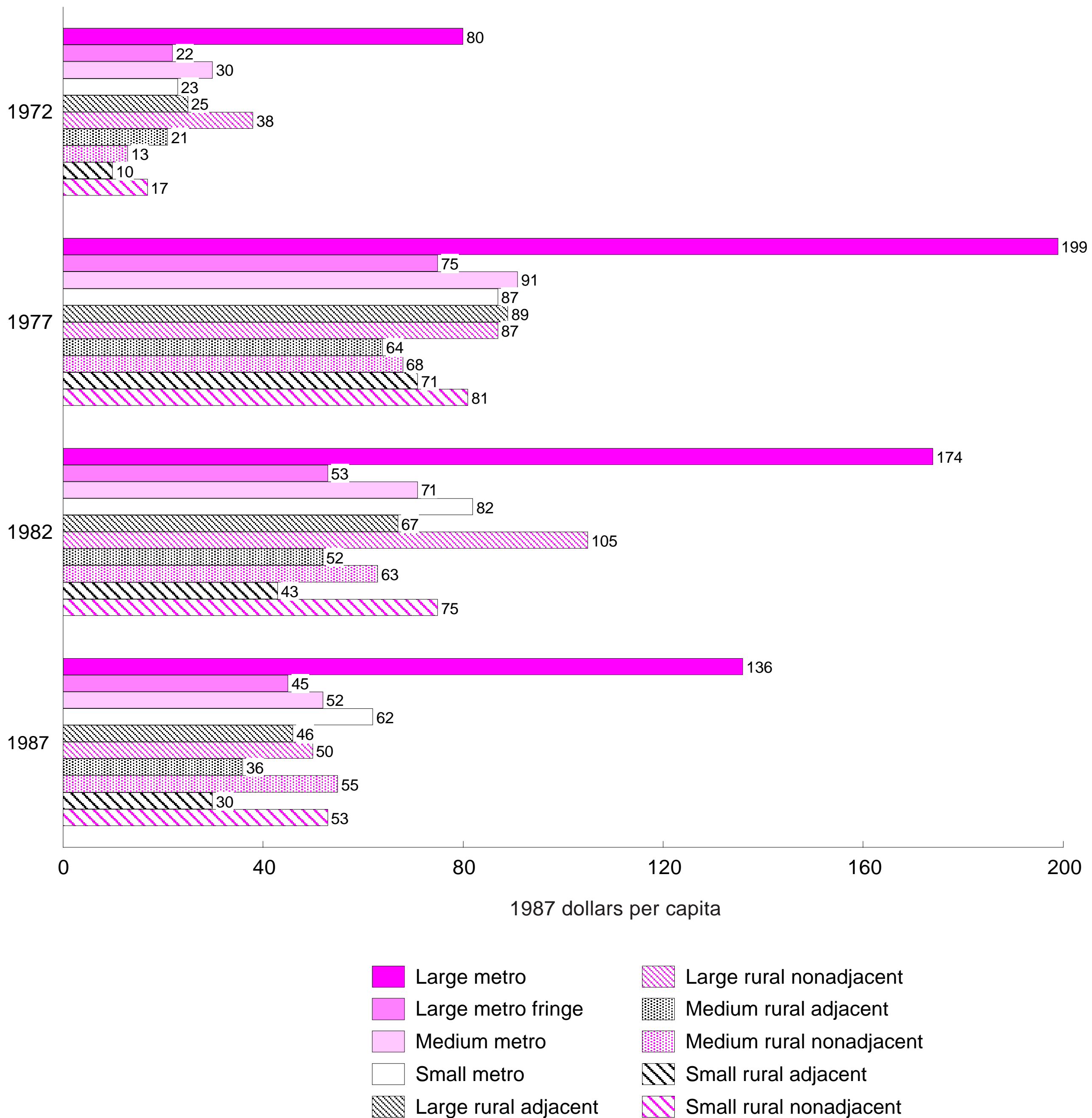
Although direct Federal aid to local governments is relatively small and has declined dramatically during 1972-87, it plays an important redistributive function—giving more to places exhibiting higher fiscal effort and higher need—both rural and urban. State aid (which includes Federal pass-through aid) is vastly larger in magnitude

Table 3
Mean revenue per capita by source, 1972-87
Local revenue primarily depends on locally raised funds and State aid

Year	Own-source revenue		State aid		Federal aid	
	Dollars	Percent of total	Dollars	Percent of total	Dollars	Percent of total
1972	738	60	476	38	23	2
1977	687	54	516	40	81	6
1982	757	59	469	36	67	5
1987	844	59	538	38	50	3

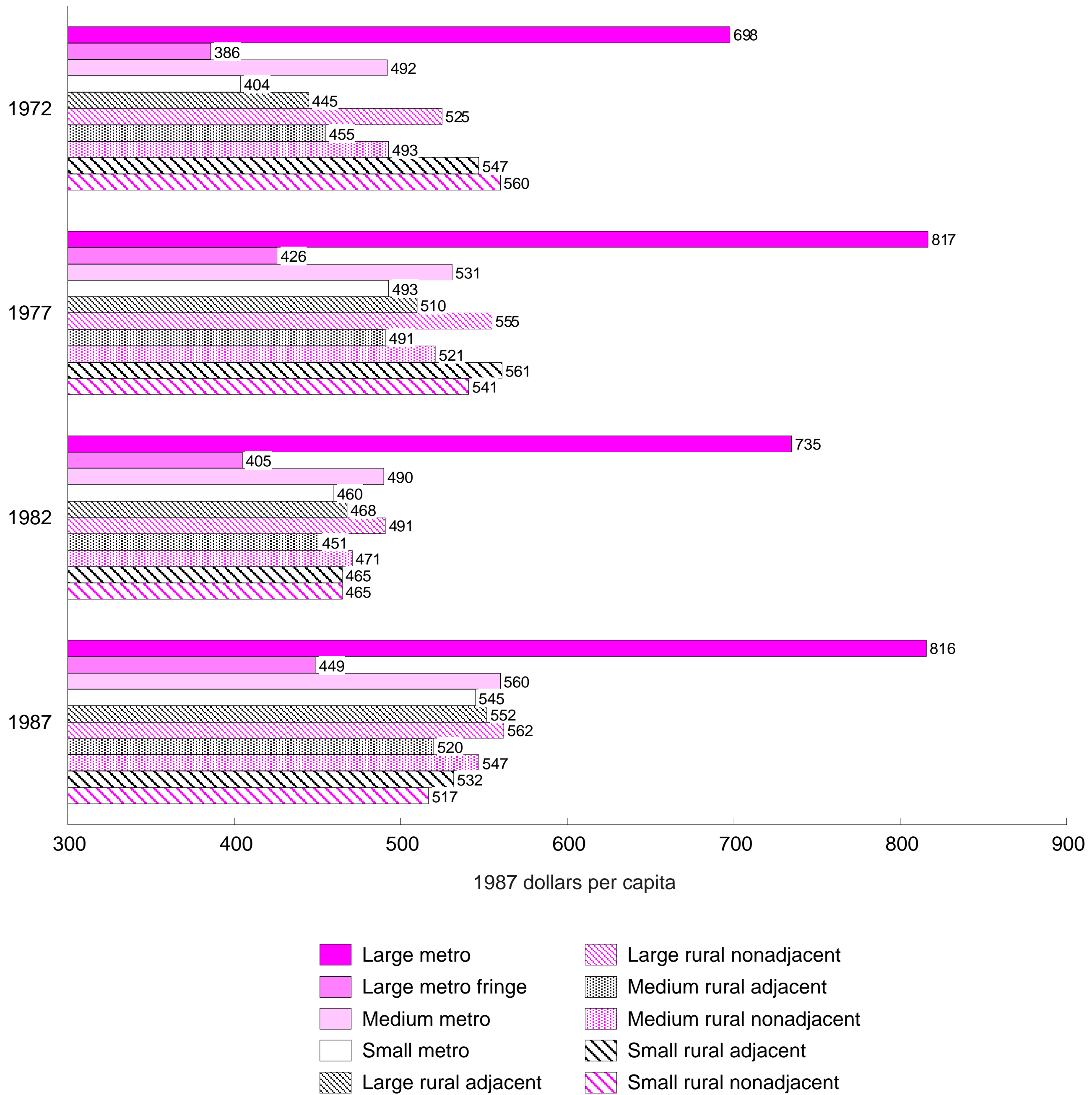
Note: Government finance data deflated by Implicit Price Deflator for State and Local Government Services, 1987=100. Mid-Atlantic and East North Central States, N=587 counties.
Source: U.S. Census of Governments 1972, 1977, 1982, 1987.

Figure 3
Mean Federal aid by county type
Federal aid favors metro core counties



Note: All government finance data deflated by GDP Implicit Price Deflator for State and Local Government Services, 1987 = 100. Per capita income data deflated by Consumer Price Index, 1987 = 100. Data reflect 587 counties in Mid-Atlantic and East North Central States.
Source: U.S. Census of Governments, 1972, 1977, 1982, 1987.

Figure 4
Mean State aid by county type
State aid favors metro core counties



Note: All government finance data deflated by GDP Implicit Price Deflator for State and Local Government Services, 1987 = 100. Per capita income data deflated by Consumer Price Index, 1987 = 100. Data reflect 587 counties in Mid-Atlantic and East North Central States.
Source: U.S. Census of Governments, 1972, 1977, 1982, 1987.

Data, Methods, and Study Region

This article reviews local government expenditure and revenue over 1972-87 among counties in eight States of the Mid-Atlantic and East North Central: Illinois, Indiana, Michigan, New Jersey, New York, Pennsylvania, Ohio, and Wisconsin.

Using census of governments data from 1972, 1977, 1982, and 1987, the study explores shifts in the level and makeup of local government revenue. Current general expenditures and revenue-raising efforts of local governments are studied as well as State and Federal aid. To compare across years and counties of different size, all government finance data are adjusted for inflation and presented on a real per capita basis. I used the Implicit Price Deflator for State and Local Government Services (*Economic Report of the President*, *1993*) to deflate government expenditures and the Consumer Price Index to deflate per capita income. The census of governments includes all governmental jurisdictions (including school districts) that operate in each county and aggregates data to the county level. Jurisdictions that cross county lines are counted in the county of their administrative headquarters.

Nongeneral expenditures (such as spending of publicly owned utilities) and capital expenditures are excluded from the analysis. Utility expenditures vary widely across place. Capital expenditures, reported in the year investments are made, vary dramatically across time. Because census figures are only available every 5 years, general expenditures, which are most comparable across place and time, are used.

Of particular interest is how expenses and revenues differ among counties across the rural-urban spectrum. Rural-urban continuum codes are developed by USDA based on data collected with each decennial census. Counties are grouped into 10 categories based on size of central place and adjacency to metro counties as follows:

Large Metro Core—central counties of metro areas of 1 million population or more;

Large Metro Fringe—fringe counties of metro areas of 1 million population or more;

Medium Metro Core—counties in metro areas of 250,000 to 1 million population;

Small Metro Core—counties in metro areas of less than 250,000 population;

Large Rural Adjacent—urban population greater than 20,000, adjacent to a metro area;

Large Rural Nonadjacent—urban population greater than 20,000, not adjacent to a metro area;

Medium Rural Adjacent—urban population 2,500 to 19,999, adjacent to a metro area;

Medium Rural Nonadjacent—urban population 2,500 to 19,999, not adjacent to a metro area;

Small Rural Adjacent—no places with population of 2,500 or more, adjacent to a metro area;

Small Rural Nonadjacent—no places with population of 2,500 or more, not adjacent to a metro area.

than direct Federal aid, and thus a more important determinant of local capacity for investment. However, the redistributive nature of State aid varies considerably across States, and is not as sensitive as Federal aid to cost differences and the greater fiscal effort of rural places (Warner). If States do not assume a more redistributive role, inequality in local investment capacity may increase for rural counties.

While intergovernmental aid is a very important tool to achieve fiscal equity, it is not the only policy option. States can help localities by assuming more responsibility for providing services and thereby decreasing the need for local expenditures. During 1972-87, most States in the Mid-Atlantic and East North Central regions increased fiscal centralization of local government services (particularly in health and welfare). States also may choose to increase local access to a wider range of fundraising mechanisms. With property tax levels already at a political maximum (as demonstrated by flat real tax revenue over the study period), local governments clearly need access to alternative taxing mechanisms if they are to assume the broader responsibilities being passed down to them with devolution. Access to a portion of State income or sales taxes would be one example. Wider access to user fees (a mechanism of increasing importance to local governments) is another option.

In a global economy, little exists to cushion localities from the vagaries of the global marketplace. This results in wide variation in local well-being across counties. To the extent that local public sector investments are deemed important to create a "level playing field" of basic services such as education and infrastructure to promote local development, we may expect to see rising inequality as a result of both market forces and widely divergent local government investment capacity. State aid to localities has the potential to play a much more significant role in equalizing local capacity for investment.

If States do not become more sensitive to the important redistributive role they play with respect to rural counties, we may see a vicious circle of increasing disadvantage develop. Economic capacity of many rural places is lower due to labor markets dominated by routine manufacturing, services, or extractive industries (McGranahan and Ghelfi). Costs of providing services are higher due to lack of economies of scale. Like their high-cost metro core counterparts, these nonadjacent rural places exhibit higher local effort. However, Federal and State aid are not significantly higher for these rural areas. Without the buffer of redistributive aid from Federal and State sources, nonadjacent rural places may find it increasingly difficult to take on important responsibilities implicit with devolution.

For Further Reading . . .

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