Federalism, New Federalism and Localism:
The Impact on Local Property Owners in California

By Lawrence A. Souza

Introduction

Federalism in the United States has and will continue to have a profound impact on the roles and responsibilities of federal, state and local governments, social policy development and administration, the redistribution and equalization of social and economic benefits, and the fairness and efficiency of tax burdens across states and local communities.

The continuation of new federalist policies under the Bush administration will continue to provide states with more flexibility and power to resolve health, education, transportation, labor and economic issues. However, due to structural budget deficits, federal and state governments will continue to push the costs of these responsibilities down to the local level.

Under new federalist policies and the reality of budget constraints, the state is allowing greater flexibility in both social policy innovation and administration at the local level. However, local municipalities now have to provide social services (un-funded or under- funded mandates) within an environment of limited funding sources, program cuts, and budget constraints.

For communities to continue to provide social services at levels demanded by federal and state governments (mandates and standards) and residents (public choice), they will need to set public policy priorities and raise revenues (taxes and fees) at the local level. This will have a direct impact on local economic activity, rent growth, occupancy rates and the value of commercial property over the long run.

Federalism

Federalism is the division of power between the federal government, sovereign states and the individual. It was created by the Constitution of 1878, a document granting powers to Congress and imposing limits on federal authority. The Tenth Amendment clarified that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." This amendment made states sovereign, providing them with independent powers and responsibilities; the ability to form their own constitution, legislative, executive and judicial branches; and pass, enforce and interpret laws, as long as they did not violate the federal constitution.

The belief is government is too big, creating the policy debate over the division of power between federal, state and local governments. Federalism shares power between states and national governments, and localism shares power between states and local governments. Historically, due to national crisis, government powers over social programs were centralized; however, under the Nixon and subsequent Regan administrations, there was a major push to devolve and transfer power and responsibility for social programs over to state and local governments.

State governments are responsible for managing budgets, enforcing laws and administering policies associated with poverty, education, the environment and crime. Some states and local jurisdictions do not have the economic, administrative, or comparative advantages necessary to fund these programs. The 1930s "New Deal" program under Roosevelt, and 1960s "War on Poverty" and "Great Society" program under Johnson, reflected the centralization of federal policy over social policy normally administered by the states.

These programs were expanded during the 1970s under Richard Nixon, what he call "New Federalism" through revenue sharing, block grants and welfare reforms. This gave states and particularly local governments significant infusions of new revenue to enhance social security, health benefits, food stamps, environmental protection and housing production.

However, under pressure to balance the federal budget, win the Cold War and cut taxes, Ronald Regan redefined federalism by devolving, decentralizing and scaling back power, funding and administrative responsibilities of the federal government for social (poverty, education and environment) programs. Regan reallocated funds away from local governmental units toward state governments to administer programs. The Clinton administration pushed power and responsibility to states and local governments, along with more revenues, through block grants, to fund mandates.

Localism

Federal social welfare mandates without additional funding have and will continue to cause states to devolve and decentralize the responsibility for healthcare, education, transportation, etc. to local cities, counties and municipalities; this is a new form of federalism called ***localism***. As federal and state funding for social-welfare programs are cut to address fiscal budget deficits, local governments will need to raise revenues to fund popular programs demanded by local residents.

To continue to fund public policy priorities (fire and safety, education, health and transportation), local jurisdictions are limited in their financing choices: raise taxes (income, sales and property), fees (administrative and exaction) or issue municipal bonds (general obligation, revenue and Mello-Roo's).

Since it is difficult or politically impossible for local governments to raise income and sales taxes, or issue municipal bonds due to funding cuts, fiscal deficits and debt limits, over the next two years, local municipalities will be forced to look to administrative fees-exactions and special property-parcel tax assessments, passed by residents during local election cycles, to fill the public revenue-expenditure gap.

As political and jurisdictional conflicts between the all levels of government are exacerbated, the ability to raise revenues and meet local needs will be limited. High and rising costs and expenses associated with additional fees, debt loads, and parcel taxes, will have an immediate and direct negative impact on local economic competitiveness, economic activity, and Net Operating Income (NOI)/value of residential and commercial properties.

Depending on the composition of the local economic base (industry mix and major employers), demographic composition (average age and household income) and fiscal health (revenue base and debt ratios), cities, counties and municipalities across California (urban, suburban, rural) will be impacted disproportionately. Localism's success as a new form of government will be dependent on the degree to which local economic and political interests are represented (advocated) at both the federal and state legislative levels, and if they can acquire funding for desired policy outcomes.

Jurisdictions with limited representation will see lower allocations of funds from state and federal governments to finance local health, safety, education and transportation needs; therefore, they will have to focus on local revenue sources, imposing higher tax burdens, to fund these priorities. Higher local taxes, be it sales or parcel taxes, will have an impact on economic growth and the value of residential and commercial properties in those jurisdictions (urban core and rural areas) over the long run.

Budgets and Budget Deficits

The 2005-2006, $2.57 trillion budget, presented by President Bush in February, assumes a $427-to-$390 billion deficit, measuring 3.5% of Gross Domestic Product (GDP). To fund this budget the president has to borrow $170 billion from the social security trust fund, cut $20 billion from domestic programs, $137 billion from entitlement programs, $1.4 billion from Amtrak, and $56 billion in education funding. The budget does not include $81 billion for the Iraq War, tax cuts that could total $1.5 trillion between 2011-2015, and the $1.0 trillion transition of social security to private accounts over 10 years.

In addition, the federal government has $7.6 trillion in public debt outstanding, $33 billion in interest, and after 2005, will have to pay $500 billion for permanent tax cuts and $700 billion for the Medicare prescription drug program. It is estimated that budget deficits will total $5 trillion over the next 10 years.

Since 2000, federal and state governments have been under severe budget pressures, causing them to cut back on social welfare, education, healthcare, transportation and other social domestic spending programs. Cuts in education, welfare and healthcare subsidies to states are motivated by the desire to cut the federal budget and allow the federal government to retreat from state and local issues.

Due to having a younger and richer population base, the state of California gives the federal government more in taxes than it receives in spending, receiving 79 cents for every dollar it sends to Washington. California pays $50 billion more a year than it receives in federal grants, contracts and other spending.

In this year's budget, President Bush is proposing deep cuts in vocational education, costing California $129 million; Medicaid, costing California $550 million this year and $4.6 billion over the next decade; and funds for undocumented immigrant incarceration, California spends $750 million per year in jail and prison costs. California will also be impacted by cuts in farm subsidies, transportation funds, and base closures; not to mention rising law enforcement costs associated with post-9/11 security.

The 2005-2006, $85.7 billion budget presented by Gov. Arnold Schwarzenegger includes $4 billion in new borrowing to close the $9.1 billion deficit, however, the state will face a $6-to-$7 billion deficit next year. With no new taxes, $3 billion in spending cuts have been targeted toward local governments, and social service programs/schools; elimination of cost-of-living increases for government workers; and up to $1.3 billion diverted from transportation funding (Proposition 42). Schools (12-K) are projected to get $2 billion less than promised, and will need to pick up $1.1 billion in pension costs.

To balance the federal budget, cuts will have to be made to non-interest expenditures. Cuts in federal spending limit the range of spending options, forcing the state to sharply reduce spending on higher education, the environment, health care, transportation, etc. Cuts in federal spending will slow overall economic activity and personal incomes in the state, decreasing state tax revenues. Lower tax revenues will lead the state to look to sales, business, corporate, gasoline taxes, etc. and other revenue sources to make up the difference. The ability to balance the budget through expenditure cuts is limited over the long run.

Conclusions

Historically, the design of federal programs left little discretion to state and local governments; however, over the past thirty years, state and local governments have been given greater flexibility to innovate program design, eligibility and funding allocations. Over the next four years under Bush's new post-new federalist policies, and the budget realities of the state, decision making and cost will be pushed further down to local governments, leading to new conflicts over distribution and control of funds for social services. The tension between California and the federal government will be replaced by tensions between Sacramento and local governments.

Interest by local authorities to finance their jurisdictions and recruit political and administrative leaders is resulting in a new form of government. Localism will conflict with national and state government goals (standards and mandates) of promoting social and economic equality, particularly if local jurisdictions are being forced to finance larger social, economic and welfare policy outcomes. Whatever the outcome, local governments under pressure to maintain and expand local social and economic policy priorities, will look to higher (parcel) taxes and (exaction) fees in response to reduced state and federal funding; this will have a direct and immediate negative impact on local economic-employment growth (multiplier effect) and commercial property values (income capitalization).

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