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GENERAL REVENUE SHARING PROGRAM

HEARINGS

BEFORE THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

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GENERAL REVENUE SHARING PROGRAM

TUESDAY, JUNE 24, 1975

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 1537, Longworth House Office Building, Hon. Richard Bolling (chairman of the subcommittee) presiding.

Present: Representatives Bolling, Hamilton, and Long.

Also present: Ralph L. Schlosstein, professional staff member; Michael J. Runde, administrative assistant; George D. Krumbhaar, Jr., minority counsel; and M. Catherine Miller, minority economist.

OPENING STATEMENT OF CHAIRMAN BOLLING

Chairman BOLLING. I am Dick Bolling, and this is the first meeting of this subcommittee. I have discovered—before I read the opening statement—I have discovered that the quality of work that is done in Congress is not determined by the size of the room.

So, rather than spending a good deal of my effort trying to get a large, empty room to use, I decided that I would use the facility that was available to us. And, if it proved adequate to those who are interested in listening, to the public, then we would continue to use this room during the period of this subcommittee's work.

I am the new chairman of this subcommittee, and I think that the work of my predecessor demonstrated that the quality of the work of a congressional committee is not determined by its drama or by the size of the room in which the work is done.

This is going to be a working operation, both in this manifestation which deals with a particular aspect of our jurisdiction, and in our broader efforts which will initially, at least for a year or two largely be steady projects rather than hearings.

This is, in effect, the initiation of an approach that I intend to pursue fairly consistently, and I apologize to all of you who have been witnesses. I know, at other times, for the shocking change from one form to another.

I hope you will find it an interesting format, and I hope our product, over time, will be useful rather than dramatic.

This morning the Subcommittee on Fiscal Policy holds the first in a series of hearings on the general revenue sharing program. Today's hearing will concentrate on suggested alternations in the revenue sharing distribution formula, focusing particularly on alternative methods of incorporating need and fiscal capacity measures into the formula.

In 1972, when revenue sharing was first enacted, there was an exhaustive and extensive debate about the structure of the allocation formula. Despite the length of the debate, criticism emerged soon after the legislation was passed.

Many felt that the formula did not sufficiently recognize the greater service needs and relatively reduced fiscal capacity of the Nation's largest and older metropolitan areas. Others suggested that the formula channeled too much money into the large urban centers, ignoring the fiscal needs of less developed but impoverished areas of the country.

These arguments certainly have not disappeared, and undoubtedly will reemerge as Congress begins its debate of reenactment. Which, incidentally—I guess all of you know seems to be a serious question as to when that debate will begin.

The witnesses that the subcommittee will hear today have spent the last 6 months researching precisely those issues that Congress debated so vigorously back in 1972. They have examined alternate formulas which incorporate different measures of service needs, alternate measures of Government fiscal capacity, and varying measures of the magnitude of Government responsibility. Their research has been sponsored by the National Science Foundation, which has generously allowed the subcommittee to have a preview of their extensive reports.

Today we will hear from four of the principal researchers on the alternate formlas projects. They are Mr. Reese Wilson, Stanford Research Institute; Mr. John Ross, Virginia Polytechnic Institute; Mr. Gregory Schmid, Institute for the Future; and Mr. Steve Rohde, Center for National Policy Review.

In addition, we are fortunate to have with us Mr. Joseph Pechman, director of the economic studies program at Brookings Institution. He will act in a variety of capacities—as a discussant, interpreter, and commentator. That is a role that sometimes I use.

I would like to ask you to limit your statements—and I mean this, because we are going to have a discussion among us as well as a presentation by each of us—limit your statements to 10 minutes so that we can have sufficient time for questioning by the members of the subcommittee—at the moment that is me—and dialog among the members of the panel.

I would like to urge you to feel free to interject comments on the work of your fellow panelists in the discussion period, as we are all here to learn. I would like to emphasize that particularly for myself. It is my opinion that this learning can best be done with a free exchange of ideas.

I would like to add a little bit to that formal statement. I opposed revenue sharing, in the beginning. I opposed it on purely philosophical grounds. I did not feel that it made sense, in terms of the representative process. I did not figure out how my constituents could divide up their decisionmaking in an election, between me who had some of the responsibility in dealing with the problem—I would raise the taxes; and those they would hold accountable for the expenditure of that portion of the money that went into revenue sharing.

I am familiar with the philosophic arguments. I think they have certain validity. At the moment, I have no rational alternative to offer, because the Congress did not adopt the rationalization of the committee structure which might have led to a better approach to categorical programs.

I intend to support revenue sharing in some form or another, simply on the expedient grounds that I have no alternative that makes any sense. And that being so, I will go along with a philosophical approach which does not seem to me reasonable—simply there being no other alternative.

This, then, makes it more important for us to discover what are the most rational ways of dealing with the program. It goes without saying that the States and the counties and the cities are thoroughly hooked on it. I think I represent an area—Kansas City, Mo., Jackson County—which has done relatively little evil with revenue sharing funds. I suspect they have done relatively well. That is my impression. And I have tried to inform myself.

But I will be very interested in what you have to say, and I hope it will be part of a relatively long, creative process, in which we improve a program which is with us, good or bad. And I am personally most grateful to you for taking your time to come and visit with us.

I am hopeful that, despite the fact that the House is meeting now, that we will get at least one other Member who will be interested in this. If they are not, I know I will be, and we will start with Reese Wilson, of Stanford Research Institute. Will you begin?

STATEMENT OF REESE C. WILSON, STANFORD RESEARCH INSTITUTE, MENLO PARK, CALIF.

Mr. WILSON. Thank you, Mr. Chairman.

The opening remarks that I will make today are taken from our final research report prepared for the National Science Foundation, coauthored with David Kaskowitz, William Grindley, and Donato D'Esopo.

SRI evaluated a number of alternatives to the current general revenue sharing allocation formula, based on two formula goals: (1) The alternative should allocate funds among local governments, according to the magnitude of their responsibilites and functions; and (2) any alternative formula should provide most assistance to jurisdictions with the greatest needs. The approach taken by SRI was to consider the present formula as a baseline, and to identify 12 components in the present formula that could be altered or replaced, individually or in various combinations. Of the 12 components, 8 were related to procedures, 3 to data elements, and 1 to the definition of general purpose governments.

The evaluation was accomplished in two parts. First, each of 27 alternative components were examined as an individual change to one of the 12 current formula components, holding the other 11 constant. This would allow one to analyze the individual impact of a single component change.

The second part of the study was directed toward the evaluation of six composite formula alternatives consisting of various combinations of the selected individual components that appeared to us to support the formula goals of allocating funds to local goverments with the greatest magnitude of responsibilities and functions, and to governments with the greatest needs.

We zeroed in on constituency needs, as opposed to the Government need. So it was local government functions, responsibilities, and needs of their constituents.

After numerous computer runs and discussions and analyses, we arrived at a preferred formula alternative that appeared to best satisfy the formula goals that we had selected.

I will go through the nine steps in the recommended formula procedure:

(1) ALLOCATION TO FEDERALLY RECOGNIZED INDIAN TRIBES

Calculation of entitlements to tribal and business councils for all Indian tribes and Alaskan Native villages recognized by the Bureau of Indian Affairs, would be made, prior to the State-area allocation.

(2) ALLOCATION TO STATE AREAS

The 51-State area entitlements using the three-factor formula and five-factor formula would be calculated as at present, but with a general tax effort factor modified to become an adjusted revenue effort factor employing taxes, selected user charges, special assessments, and other selected general and nongeneral revenues.

(3) DIVISION BETWEEN STATE AND LOCAL GOVERNMENTS

The State government would be entitled to one-third of each State area allocation as in the present formula. The remainder, known as the local share, would be allocated among units of general-purpose, local government, within each State, using the definition of "general purpose local government" as defined by the Bureau of the Census for general statistical purposes.

(4) DESIGNATION AND ALLOCATIONS TO STATE-RECOGNIZED INDIAN TRIBES AND ALASKAN NATIVE VILLAGES

The Governor of each State would designate those Indian tribes and Alaskan Native villages as State-recognized tribal recipients which, in the Governor's determination, possess powers and perform the functions of a unit of local general-purpose government. These recipients, generally, would be tribes or villages whose reservations lands are held in trust by the State government.

Let me resummarize up to the point where we are now. The national entitlement for an entitlement period, the first allocation would be made to federally recognized Indian tribes, as determined by the Bureau of Indian Affairs. The remaining national entitlement would then be divided into 51 State area shares. Each State area share would be split into one-third for the State governmet, and two-thirds for local governments, as is done now. Out of the two-thirds local share, the Indians recognized by the State, but not by BIA, would get their allocation from the local share. The remainder, then, is going to be allocated to the local governments within the State.

(5) DIVISION AMONG CATEGORIES OF LOCAL GENERAL PURPOSE GOVERNMENTS

The remainder of the local share would be divided among categories of local government—counties, places, townships, city-counties, and, if any exist in the state, township-counties—in proportion to adjusted revenues. This would establish the local share for each category of government within a State. Allocations to governments would be made separately by category and would be based on the modified, three-factor formula—allocations to governments within each category proportional to the product of population, the relative income factor, and the general revenue effort factor. The three-factor formula, then, is only changed in one component from the present three-factor formula, and that is that the general tax effort factor becomes a general revenue effort factor. In other words, adjusted revenues are substituted for adjusted taxes, in the last factor in the three-factor formula.

(6) DEVELOPMENT AND APPLICATION OF THE PER CAPITA CATEGORY SHARE CONSTRAINT

The amount of each category's share, divided by the population residing in jurisdictions of the category, would equal the per capita category share. Take the category of "cities, and other places", for example. The total population residing in those cities and places within a State, would be divided into the portion of the local share allocated to that category to determine the per capita category share. The amount allocated to any local general-purpose government would not exceed 300 percent of this per capita category share, but may be as low as zero percent of the per capita category share. If the per capita allocation to a local unit of government,including counties, was more than 300 percent, its allocation would be reduced to that level, with any surplus going to unconstrained local governments, or, failing that, to the State government.

(7) APPLICATION OF THE BUDGET CONSTRAINT

If the amount allocated to a local government, other than a county, was greater than 20 percent of the sum of adjusted revenues and intergovernmental transfers, its allocation would be reduced to that level and the excess would be given to the county government. After the 20-percent budget constraint was applied to other local governments, it would be applied to county governments, with the surplus going to the State government.

In the current formula, the 50-percent budget constraint has the same effect, of passing money up from local governments to the county government, and up to the State government. The 20-percent budget constraint does the same thing but with a greater effect.

(8) APPLICATION OF THE DE MINIMIS RULE

If any recipient government's allocation were less than $200 for any entitlement period of any duration, or if the unit waived its entitlement, the allocation would revert to the government at the next highest level. This is the same as in the current formula.

(9) ITERATION

As in the present formula, if the amounts allocated by the above procedure do not total 100 percent of the State area allocation, the appropriate adjustment would need to be made and the process repeated, until all money allocated to each State area had been, indeed, allocated to each government within a State.

That is the formula alternative preferred by SRI. The alternative was selected because (1) it meets the formula goals better than any other composite formula evaluated by SRI; (2) it contains most of the high-priority, individual changes identified by SRI; and (3) it meets operational and practical considerations better than any other alternative studied.

The composite formula alternative preferred by SRI appears to be relatively better at rewarding high-responsibility, high-need governments than either the current formula, or any other alternative evaluated by SRI.

All of the composites investigated by SRI contain the changes which were judged to be of the highest priority. These were as follows: raising the upper per capita local share constraint from 145 percent to 300 percent, and dropping the 20-percent lower per capita share constraint; lowering the budget constraint from 50 to 20 percent of adjusted revenues plus intergovernmental transfers; substituting for adjusted taxes, an adjusted revenues measure.

In addition, the composite formula preferred by SRI contained a procedural step to eliminate county area allocations so that governments within the same categories compete among themselves with a separate 300-percent constaint established by category.

Chairman BOLLING. If I may, I will interrupt at that point, and will include the rest of your statement—all of your statement, and the part that you skipped, as well.

You hit the high points, as I read it, and I stopped you before your conclusion, but we will get that in the record. I would like to try to hold to my 10-minute suggestion, roughly, and I will say at this time that unless there is an objection we will include the full statement in the record at this point.

[The prepared statement of Mr. Wilson follows:]

PREPARED STATEMENT OF REESE C. WILSON

General Revenue Sharing Formula Alternatives[1]

DEVELOPMENT OF A PREFERRED FORMULA ALTERNATIVE

SRI evaluated a number of alternatives to the current GRS allocation formula that promised to allocate funds among local governments according to the magnitude of their responsibilities and functions, and to provide most assistance to jurisdictions with the greatest needs. The approach taken by SRI was to consider the present formula as a baseline and to identify 12 components that could be altered or replaced, individually or in various combinations. Of the 12 components, 8 were related to procedures, 3 to data elements, and one to the definition of general purpose governments.

[1] Excerpted from "General Revenue Sharing Formula Alternatives," by Reese C. Wilson, David H. Kaskowitz, William C. Grindley, and Donato A. D'Esopo, Stanford Research Institute, Menlo Park, Calif. (June 15, 1975).

The evaluation of promising formula alternatives was accomplished in two parts. First, each of 27 alternative components was examined as an individual change to one of the 12 current formula components, with the remaining 11 components unchanged. This resulted in nine alternative components being selected as warranting individual consideration in any new formula.

The second part of the study was directed towards the evaluation of six composite formula alternatives consisting of various combinations of the selected individual components.

DESCRIPTION OF THE PREFERRED GRS FORMULA ALTERNATIVE

The GRS formula alternative preferred by SRI, resulting from several detailed analyses, consists of the following steps:

(1) *Allocation to Federally Recognized Indian Tribes.*—Calculation of entitlements to tribal and business councils for all Indian tribes and Alaskan native villages recognized by the Bureau of Indian Affairs would be made prior to the State-area allocation. This would reduce the overall entitlement amount available to state-areas in Step 2, below. The allocation to each Federal Indian tribe and Alaskan native village would be determined by the product of the resident reservation population multiplied by the national per capita allocation (total amount divided by U.S. population).

(2) *Allocation to State-Areas.*—The 51 state-area entitlements using the three-factor fomula and five-factor formula would be calculated as at present, but with the general tax effort factor modified to become an adjusted revenue effort factor employing taxes, selected user charges, special assessments, and other selected general and nongeneral revenues. Data elements included in the three-factor formula would be population, per capita income, personal income, and adjusted revenues; the five-factor formula would also include tax collections and urbanized population.

(3) *Division Between State and Local Governments.*—The State government would be entitled to one-third of each state-area allocation. The remainder would be known as the local share and allocated among units of general-purpose local government, as defined by the Bureau of the Census for general statistical purposes, and State-recognized Indian tribes and Alaskan native villages.

(4) *Designation and Allocations to State-Recognized Indian Tribes and Alaskan Native Villages.*—The Governor of each State would designate those Indian tribes and Alaskan native villages as State-recognized tribal recipients which, in the Governor's determination, possess powers and perform the functions of a unit of local general-purpose government. These recipients generally would be tribes or villages whose reservation lands are held in trust by the State government. Each tribal or village council would receive an allocation based on the size of the resident reservation population multiplied by the per capita local share for the State.

(5) *Division Among Categories of Local General Purpose Government.*—The remainder of the local share would be divided among categories of local government (counties, places, townships, city-counties, and—if any exist in the State—township-counties) in proportion to adjusted revenues. This would establish the local share for each category of government. Allocations to governments would be made separately by category and would be based on the modified three-factor formula—allocations to governments within each category proportional to the product of population, the relative income factor (the inverse of per capita income), and the general revenue effort factor (adjusted revenue divided by total money income).[2]

(6) *Development and Application of the Per Capita Category Share Constraint.*—The amount of each category's share divided by the population residing in jurisdictions of the category would equal the per capita category share (PCCS). The amount allocated to any local general purpose government would not exceed 300% of the PCCS, but may be as low as 0% of the per capita category share. If the per capita allocation to a local unit of government, including counties, was more than 300% of the PCCS, its allocation would be reduced to that level (population multiplied by 300% of the PCCS), with any surplus going to unconstrained local governments or, failing that, to the State government.

(7) *Application of the Budget Constraint.*—If the amount allocated to a local government, other than a county, was greater than 20% of the sum of adjusted

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[2] As in the current formula, this would reduce to adjusted revenues divided by the square of per capita income.

revenues and intergovernmental transfers, its allocation would be reduced to that level and the excess would be given to the county government. After the 20% budget constraint was applied to other local governments, it would be applied to county governments, with the surplus going to the State government.

(8) *Application of the De Minimis Rule.*—If any recipient government's allocation were less than $200 for any entitlement period of any duration or if the unit waived its entitlement, the allocation would revert to the government at the next highest level, provided that government were, on its own account, an eligible recipient.

(9) *Iteration.*—As in the present formula, if the amounts allocated by the above procedure do not total 100% of the State-area allocation, the appropriate adjustment would need to be made and the process repeated (from Step 5).

MODIFICATION OF THE INTERSTATE FORMULA

The major focus of this study has been on the intrastate portion of the allocation formula. One modification of the interstate formula is recommended, based on this work. A major modification of the intrastate formula was the expansion of adjusted taxes to include other sources of revenue. The arguments for modifying this data element in the intrastate formula apply as well as to the interstate formula, except that, consistent with the current Act, education revenues would be included at the State level. The allocations to state areas under this alternative are only slightly different from those of the current formula for most States so that the impact of this change is minimal with most increases and decreases well under 10%. But for the reasons given for replacing taxes with revenues at the local level, and to maintain consistency between the interstate and intrastate formulas, this modification is proposed for the interstate allocation formula as well.

SUMMARY

The preferred formula alternative was selected because (1) it meets the formula goals better than other composites evaluated by SRI; (2) it contains most of the high-priority individual changes identified by SRI; and (3) it meets operational and practical considerations better than any other alternative studied. The composite formula alternative preferred by SRI appears to be relatively better at rewarding high-responsibility high-need governments than either the current formula, or other alternative evaluated by SRI. Although four other composite formulas moved greater allocations toward governments with even higher responsibilities, they were from slightly to substantially less income-redistributive than the current or preferred formulas.

All of the composites investigated by SRI contained the procedural and data element changes which were judged to be of the highest priority. These were as follows:

Raising the UPCLS constraint from 145% to 300% and dropping the 20% lower per capita local share.

Lowering the budget constraint from 50% to 20% of adjusted revenues plus intergovernmental transfers.

Substituting for adjusted taxes an adjusted revenues measure that includes adjusted taxes, user charges, special assessments and selected general and non-general revenues.

In addition, the composite formula preferred by SRI contained:

Changing the procedural step to eliminate county-area allocations so that governments within the same categories compete among themselves with a separate 300% per capita local share constraint established by category.

The composite is also attractive because it is immediately operational with a small incremental cost. Preliminary discussions with the Government Division of the Bureau of the Census indicated that expansion of adjusted taxes, to adjusted revenues, would basically be a problem of expanding the Annual GRS Survey instruction sheets to the local governments filling out such forms, and to the 25 State governments now performing that function for their local governments. This cost is likely to be an additional, one-time expense of approximately $100,000. Likewise, the computer software program used by the Office of Revenue Sharing would have to be modified to account for the adjusted revenues data element, the new constraints, and a nonhierarchical structure. For purposes of this study SRI redesigned the present allocation program to make it more efficient. This was done within a minimum of time, and indicates that new software could be developed by ORS for a one-time cost of less than $100,000.

Congress and other bodies responsible for, or having interests in the GRS program, are urged to consider the preferred GRS formula alternative presented above. SRI believes that quick implementation of such a formula is feasible from the legislative, operational, and cost viewpoints, if Congress accepts the alternative preferred by SRI, all or in part.

Chairman BOLLING. But I will move on, if I may, so that we may have some time for an interchange.

The next witness will be Mr. John Ross, of VPI.

STATEMENT OF JOHN P. ROSS, CENTER FOR URBAN AND REGIONAL STUDIES, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY, BLACKSBURG, VA.

Mr. ROSS. Thank you, Mr. Chairman.

The purpose of our study was to examine and test alternative revenue sharing formulas which would provide most assistance to cities and counties with the greatest needs. The goal of the study was to identify an operational formula which would better reflect jurisdictional need for Federal aid better than does the present formula.

The steps, in carrying out that goal, were really quite straightforward. The first step was to establish criteria which might be used to estimate variations in need. The second step was to test the present formula against those criteria to see how well it responded to variations in need. The third step was to develop a new formula which would be more responsive to our needs criteria. The final step was to test that new formula and using it, estimate allocations for the entire United States. The concentration of our study was on the intrastate formula and looked primarily at city and county governments.

The two criterion were developed for estimating variations in need. The present intrastate formula contains two factors, population and relative income, which may be considered proxies for need. The problem is that both of these factors are measures of "average" characteristics when in fact it may be the extremes of the distribution which determine the needs of a community.

Thus, we developed an index which provided us with a measure of the distribution of the needy community residents. The responsiveness of the formula to differences in our needs index was one criteria used to evaluate the formula.

The second criterion looked at relative income as it is specified in the present formula. For the present formula to be responsive to need, one would want it to respond to changes in relative income. In other words, one would want it to provide more funds to areas with higher relative incomes, as "relative income" is defined in the formula.

After establishing these two needs criterion, the present formula was examined. What we found was that the three factors in the present intrastate formula were not of equal importance. The formula is most responsive to differences in population size. If per capita allocations are examined, it is most responsive to differences in tax effort. It is responsive to differences in relative income, but not as responsive.

The next step was to examine the bounds to see whether they made the formula more or less responsive to our needs criteria. What we found was that each one of the bounds, the 145-percent constraint, the 20 percent, and the 50-percent constraint, reduced the responsiveness of the formula to need, as we defined it.

One of the problems which occur when the bounds are removed is that of outlayers. You get some very high per capita allocations—some of up to $75 per capita. We examined those outlayers and found that most of them were for places of less than 450 in population. For those places, the income figures—the way I understand it—are not reliable. They are estimated from the county per capita income. Given that it would seem that this is where most of the outlayers occur; there is some problem in using county per capita income to estimate the relative income of the very small places.

Based on these findings, we examined other formulas which might be more responsive to need. We examined a number of different formulas, primarily falling into three categories. First, we looked at changes in the population factor. If we changed the population factor, could we make the formula more responsive to our two criteria? Second, we examined changes in the tax effort factor, and the relative income factor.

Finally, we examined the possibility of including an additional factor. We found that best results were obtained by including an additional factor in the three-factor intrastate formula. The factor that we included was the percent of families below the poverty line.

The new formula has a number of advantages. First, it is more responsive to variations in need between jurisdictions as defined by our criteria. Second, the formula is much simplier than the present formula. The constraints have been a source of confusion all the way along. And third, the formula is not a drastic or radical change from the present formula.

Given this new formula, we then estimated allocations for the entire United States. Without the bounds, the range of allocations was increased with some of the allocations up to $90 per capita. We looked at population size and our new allocations. We found that both the large gainers and the large losers had populations of less than the average for all population groups, and that the large gainers tended to have smaller populations than the large losers.

Based on these findings, then, we wold recommend that in order to make the formula more responsive to cities and counties with the greatest needs, a poverty factor should be included as a fourth factor in the intrastate allocation process.

Second, in order to make the formula more responsive to cities and counties with the greatest needs, if the poverty factor is included in the formula, the bounds should be dropped.

Third, given the problem of the reliability of the estimate of relative income, we suggest that for the very small places where reliable estimates of relative income are questionable, the allocations be made on a per capita basis.

[The prepared statement of Mr. Ross follows:]

PREPARED STATEMENT OF JOHN P. ROSS[1]

Alternative Formula for General Revenue Sharing: Population Based Measures of Need

PURPOSE

The purpose of this paper is to provide a summary of the results of our study which examined and tested alternative revenue sharing formulae which would provide the most assistance to cities and counties with the greatest needs. The goal of the study was to identify an operational formula which would reflect jurisdictional need for federal aid better than the present formula does. Although some attention was given to the interstate formula, the intrastate allocation process was emphasized. Detailed analyses were conducted on a five state sample using allocations for the first entitlement period.

METHOD

The first step in carrying out this study was to develop quantitative criteria which could be used to measure differences in need. The present intra-state formula contains three factors, populations, tax effort and relative income. Two of these factors, population and relative income, are at least crude proxies for disparities in need. Thus one criteria which may be used to determine the relationship between the formula and need is to examine the responsiveness of the allocations to changes in these needs proxies. In other words, if the community's relative income goes up, holding all else constant, does the allocation also go up if so, by how much?

The focus of these two factors in the present formula is on the average characteristics of the community when in fact, it may be the extremes which determine needs. For example, the needs of a 100 person community in which half of those persons are over sixty-five will be different from those of a 100 person community with only three people over sixty-five, even though the population size of the two jurisdictions is identical. Thus the distribution of both population and income within a community is important in determining its relative needs.

Based on these arguments, two criteria for identifying the formula's responsiveness to relative need were developed. The first was the responsiveness of the formula to changes in relative income. The second was an index based on factor analysis which provides an indication of the distribution of needy community residents.

The second step in the study was to analyze the present revenue sharing formula with respect to its responsiveness to the above criteria. A number of modifications were then developed and tested. Based on this analysis a new formula which is more responsive to both of our criteria was chosen and tested for the five state sample. Finally, allocations from the new formula for the entire United States were estimated and analyzed.

FINDINGS

The method employed in this study yielded a number of interesting findings concerning the present formula. First, as would be expected, the three factors in the intra-state formula are not of equal importance in determining the allocation.

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[1] This paper is based on the findings of a study conducted by John P. Ross, Richard D. Gustely, Judson L. James, Ann D. Watts, and Thomas M. Watts, members of the staff of the Center for Urban and Regional Studies; Virginia Polytechnic Institute and State University; Blacksburg, Virginia. The study was prepared with the support of the National Science Foundation Grant No. APR75-05211. However, any opinions, findings, conclusions, or recommendations expressed herein are those of the authors and do not necessarily reflect the views of NSF.

If total allocations are examined, population is by far the most important factor determining the amount of funds a city will receive. Tax effort is second in terms of relative importance while relative income is the least important of the three factors. Tax effort is also relatively more important in determining the per capita allocation going to an individual city than is relative income. Holding all else constant, on the average a one percent change in tax effort will change the per capita allocation of the city by $0.03 whereas a one percent change in relative income will change the per capita allocation by $0.02.

Second, the imposition of the 145 percent, 20 percent, and 50 percent bounds tends to reduce the responsiveness of the present formula to changes in both tax effort and relative income. If the bounds are removed, the formula is more responsive to our needs index as well. There is, however, some cost involved in removing the bounds. On the average, removing the 145 percent bound provides the greatest reward to relatively small cities with high tax efforts in the relatively wealthy, populous states while doing little toward increasing the responsiveness of the formula to either relative income or our needs index. With the 145 percent dropped, dropping the 20 percent bound increased the responsiveness of the formula to tax effort, relative income and our needs index. On the average, dropping this bound tended to increase the per capita allocations to large cities while reducing the per capita allocation to the smaller cities. Within our sample, eleven cities of over 100,000 gained more than $0.10 per capita when this bound was removed. Finally, dropping the 50 percent bound affected only relatively small cities in the sample. Only three cities in the sample affected by this bound had populations over 3000. In other words, this bound had very little effect one way or the other on cities within our sample.

Removing the bounds on the present formula has the additional effect of increasing the range of per capita allocations. In some places per capita allocations were over $75. These large per capita allocations were investigated and found to occur primarily in places of less than 450 in population. Per capita income for places this size are not available and hence are estimated by the per capita income of the county in which these places are located. These very large per capita allocations would tend to indicate that there may be some problems with estimating per capita income in this fashion.

Based on these findings, it may be concluded that the present formula is at least to some extent responsive to differences in need between communities. The formula can, however, be made more responsive to variations in need. In order to improve its responsiveness, a number of modifications were tested. These modifications ranged from very simple changes, such as lifting one or more of the bounds, to the exotic, such as multiplying the tax effort term by the proportion of persons in poverty. These formula modifications were of two general types. The first type altered the factors in the present intra-state formula. The second type included an additional factor which more explicitly accounted for differences in the people-based needs of the jurisdictions. The changes were analyzed in terms of the two criteria identified earlier in the study and were examined both with and without bounds.

From this analysis, three general conclusions were drawn. First, the inclusion of a fourth factor, particularly a poverty factor, made the greatest impact on the responsiveness of the formula to needs. It made the formula much more responsive to disparities in need among the jurisdictions. Second, the responsiveness of the formula to population based needs is severely limited by the inclusion of any bounds. Finally, because of the poor quality of the income related data for small areas, if relative income is to be made more important in the formula, then allocations to the smallest jurisdictions should be made on a per capita basis. The poor quality of the income related data makes it impossible to determine the actual relative need of these small jurisdictions.

Given these findings, the formula chosen as the most responsive to population-based need at the intra-state level was a formula containing population, tax effort, relative income, and the percent of families under the poverty line. The formula may be written as follows:

Local Government Allocation=

$$(\text{Jurisdiction Share})\frac{(\text{POP})\,(\text{TE})\,(\text{RI})\,(\text{Percent Families Below Poverty Line})}{\Sigma(\text{POP})\,(\text{TE})\,(\text{RI})\,(\text{Percent Families Below Poverty Line})}$$

The 145, 20, and 50 percent bounds were excluded from the formula. Only the $200 minimum allocation rule remains. Because of the problems with income data for small places, the formula was used for only places over 1,000 in population size, with per capita allocations being given to those very small places.

This formula has a number of advantages. First, as defined by our criteria, it is much more responsive to variations in need between jurisdictions than is the present formula. Second, the formula is much simpler than the present formula. The bound requirements have been a constant source of confusion. The elimination of those bounds makes the intra-state part of the general revenue sharing formula much easier to understand. Third, the proposed formula is not a radical change from the present formula.

The new formula was analyzed in terms of its responsiveness to need as compared to the present formula. As would be expected, the new formula is more responsive for all governmental types. For example, for cities the responsiveness of the new formula to changes in our index is almost five times higher than the old formula. Similar results were found for both county and township governments. The new formula increased the range of per capita grants with-some places receiving as much as $90 per capita. With respect to population size, both the large gainers and the large losers tended to have smaller populations than the average with the large gainers tending to have relatively smaller populations than the large losers. Finally, the large gainers tended to have higher relative incomes and greater percentages of persons in poverty than did the large losers.

RECOMMENDATIONS

1. *In order to make the formula more responsive to cities and counties with the greatest needs, a poverty factor should be included as a fourth factor in the intra-state allocation formula.*

2. *In order to make the formula more responsive to cities and counties with the greatest needs, if the poverty factor is included in the formula, the 145 percent, 20 percent, and 50 percent bounds should be removed.* If the formula is not changed, the argument concerning bounds is much less conclusive.

3. *Governments for which reliable estimates of relative income and percent of persons below the poverty line are not available should receive allocations on a per capita basis.*

Chairman BOLLING. Thank you.

Next, Mr. Gregory Schmid, Institute for the Future.

STATEMENT OF GREGORY SCHMID, INSTITUTE FOR THE FUTURE, MENLO PARK, CALIF.

Mr. SCHMID. Thank you, Mr. Chairman.

The current revenue sharing allocation formula is based upon several procedures which, by their very nature, produce different allocations for many jurisdictions with similar needs. These distorting procedures include the tiering mechanism, the complex constraints associated with tiering, and the fixed State/local split. The Institute for the Future believes that these procedures can and should be modified or completely eliminated to make the formula a more equitable allocation agent.

The revenue sharing project at the institute has been based on the assumption that one basic goal of the revenue sharing law should be to provide the greatest assistance to those State and local governments with the greatest needs. This assistance, however, should be provided without distorting local variations in the financing or delivery of services.

In order to base actual allocations of money on such a general goal, we have set up evaluation criteria by which to measure the current formula and any suggested alternatives. These criteria have taken the form of an evaluation index which measures a given jurisdiction's need for revenue sharing funds by considering both its service requirements and the tax effort the jurisdiction makes in fulfilling these requirements, given its financial base. The service requirements include the traditional categories of spending for State and local general-purpose governments: health, welfare, recreation, sanitation, transportation, and public safety. An independent component index has been calculated for each service category for fiscal effort and financial ability; these have been combined into a single comprehensive evaluation index. This comprehensive index provides a measure of need and effort for each of the 50 States and for a random sample of counties, townships, and municipalities representing diverse sizes, locations, and types of communities.

Using the evaluation index, it has been found that an alternative to the present formula could more effectively provide greater assistance to those communities with the greatest needs. The present formula is inhibited in achieving this goal by its use of a tiering mechanism and by the complex limit arrangements that are needed to minimize tiering distortions, but which create distortions of their own. In contrast, the institute has derived a simple alternative formula.

The institute's formula uses only three of the five current data elements. It is presented in a slightly different functional form which provides a better fit to the evaluation index than the current formula. In addition, it replaces the tiering mechanism with simple national pools in which like governments compete with each other equally. The formula thus avoids the problem of widely varying allocations to basically similar communities where such variations are due solely to geographic location. This feature has greatly reduced the need for limits and constraints. Finally, the formula introduces some flexibility into the State/local split, thus ending penalties on allocations to smaller centralized States.

As measured by the evaluation index, the institute's formula distributes money more equitably than the current formula at every jurisdictional level. Measuring the allocations produced by the institute's formula and the current formula against the evaluation index, we have found that the institute's formula provides a moderately better fit in allocations to the total State areas, a substantially better fit in allocations to State governments, and a moderately better fit in allocations to local governments. At the same time, the number of jurisdictions which actually receive allocations and which are affected by formula limits has been reduced from over 11,000 under the current formula, to under 1,000 under the institute's alternative formula.

Besides meeting the evaluation criteria better and simplifying the need for limits, the institute's formula makes some relative changes in allocations to certain types of communities. It tends to increase allocations to large, older urban governments. It reduces the amount of money allocated to wealthy suburban communities and to exceptional types of communities that receive inordinately high allocations under the current formula. And it is far less susceptible to differential treatment of similar communities due exclusively to geographic location.

All of these characteristics can be seen from examples of comparative allocations under the current formula and the institute's formula using the allocation amount and data elements from entitlement period I. All the examples given are taken from detailed tables which are appended to the statement.[1]

[1] See tables, pp. 16–17.

The institute formula allocates, on the average, larger per capita total shares to the Nation's largest cities. However, the degree of increase is much larger for the "older" cities of the Northeast and North Central States—which have aging core areas and middle class exodus problems—than for those cities which have grown rapidly in the past 3 decades.

Of the 25 largest U.S. cities, the older, slow-growth cities—such as New York, Philadelphia, and Cleveland—receive an average increased total share of about $2.50 per person. The newer, expanding cities—such as Los Angeles, Houston, and Denver—average an increase of about $0.30 per person.

Wealthy suburban communities and counties receive decreased per capita shares under the institute formula. In a sample of 25 of the wealthiest suburban communities in the United States, all 25 received smaller allocations both on a city level and on a city/pro-rated county share basis. Per cepita allocations to such communities as Beverly Hills, Calif.; Lake Forest, Ill.; Bloomfield Hills, Mich.; and Scarsdale, N.Y., were cut by more than 50 percent.

Industrial enclaves and resort communities which receives inordinately large shares under the current formula due to their large tax base are allocated fewer funds in line with their real needs. The allocations to most of these types of communities, such as Commerce City and Industry City, Calif.; and Vail, Colo.; are reduced by $3 to $4 per person. In some cases, as in Dering Harbor and Ocean Beach, N.Y., the reduction is nearly $10 per capita.

Theoretically, any local government which has the same tax effort and the same per capita income as any other local government should receive the same per capita allocation—whether it be a city, county, or township. The institute's pooling arrangement approximates this goal much better than a tiering arrangement. Several geographically dispersed county areas with similar per capita incomes and tax efforts have been compared. Whether one looks at the per capita county area allocations by themselves, or adds a pro rated State per capita allocation, the institute formula substantially reduces the range in allocations; that is, the difference between the highest and lowest, and the total amount of variance from the sample average.

In its research, the institute has identified several procedures in the current formula which cause distortions in allocations. By focusing on a single goal—that of providing the greatest assistance to those jurisdictions with the greatest needs—we have provided a measurement of that distortion.

We have also found an alternative formula which meets that goal more effectively than the current one does. Because of the inherent distortions in the formula, we strongly recommend that Congress first eliminate the current tiered allocation arrangement; two, modify the complex limit constraints which are strongly tied to the distortions of a tiered formula; and third, modify the arbitrary one-third/two-thirds split between State and local governments.

The institute has provided both an alternative formula which makes these adjustments, and an evaluation process which permits one to measure the impact of allocations under the current formula and various alternatives.

[The tables referred to by Mr. Schmid follow:]

TABLE 1.—COMPARISON OF ALTERNATIVE ALLOCATIONS AGAINST THE EVALUATION INDEX (AS MEASURED BY A PEARSON CORRELATION COEFFICIENT [1])

	State area allocation	State government allocation	Local government allocation
Current formula	0.7823	0.5930	0.3453
Institute for the future formula	.8342	.8152	.4346

[1] A coefficient value of 1 would indicate complete agreement with the evaluation index while a value of 0 would indicate no agreement at all.

TABLE 2.—ALLOCATION TO MAJOR CITIES

	City per capital allocations		City plus county plus State allocations per capita	
	IFTF formula	Current formula	IFTF formula	Current formula
Old cities: [1]				
New York City	16.00	13.49	20.71	18.84
Chicago	8.55	9.23	14.21	14.63
Philadelphia	15.71	11.32	22.04	15.22
Detroit	11.91	12.15	19.41	18.54
Baltimore	12.35	13.12	17.40	17.64
Cleveland	12.35	9.65	18.06	15.66
Milwaukee	7.40	8.74	19.10	19.52
San Francisco	11.80	12.38	16.16	17.03
Boston	20.20	13.95	24.51	18.76
St. Louis	17.66	10.10	21.95	13.58
New Orleans	10.90	14.34	20.41	20.00
Pittsburgh	11.80	11.32	20.91	19.00
New cities: [2]				
Los Angeles	5.51	5.62	15.80	16.26
Houston	5.78	6.04	[2] 12.35	[2] 11.45
Dallas	6.48	6.87	12.47	11.69
Indianapolis	5.94	7.44	10.18	11.07
San Diego	4.49	4.50	13.00	13.22
San Antonio	6.47	6.49	[3] 12.87	[3] 11.75
Honolulu	9.05	9.47	17.52	14.57
Memphis	7.97	9.05	[4] 17.38	[4] 16.92
Phoenix	5.46	6.60	14.53	13.88
Columbus	6.08	5.99	10.94	10.99
Seattle	4.30	7.84	[5] 11.87	[5] 14.14
Jacksonville	7.59	7.59	13.85	11.17
Denver	9.69	11.47	14.59	15.56

[1] Old cities are those whose growth rate in the period 1940–70 is less than 50 percent; new cities more than 25 percent.
[2] Includes Harris County portion only.
[3] Includes Bexar County portion only.
[4] Includes Shelby County portion only.
[5] Includes Kings County portion only.

TABLE 3.—ALLOCATIONS TO WEALTHY SUBURBAN COMMUNITIES

	Per capita income	Per Capita city allocation		City and county IFTF formula	Prorated share current formula
		IFTF formula	Current formula		
Mountain Brook, Jefferson County, Ala	$8,059	0.7260	1.7438	4.3897	6.5408
Scottsdale, Maricopa County, Ariz	3,889	3.1647	3.9562	5.2887	6.5496
Atherton, San Mateo County, Calif	9,106	.4354	1.8604	2.9154	4.5192
Beverly Hills, Los Angeles County, Calif	11,159	.8250	1.8604	6.7524	7.8409
Hillsborough, San Mateo County, Calif	10,820	.7800	1.8604	3.2600	4.5192
Palm Springs, Riverside County, Calif	5,174	2.1829	7.1840	9.8080	14.6092
Sausalito, Marin County, Calif	7,879	.9989	1.8603	3.4360	4.5302
New Canaan, Fairfield County, Conn	8,442	1.0146	1.7651		
Bal Harbour Village, Dade County, Fla	11,289	.8234	2.5304	4.8149	6.5132
Palm Beach, Palm Beach County, Fla	15,286	.8083	1.4323	3.2984	3.9957
Highland Park, Lake County, Ill	7,432	1.0726	1.7072	2.4106	3.4402
Lake Forest, Lake County, Ill	7,619	1.0388	2.3795	2.3768	4.1125
Winnetka, Cook County, Ill	9,904	.8512	1.6353	1.9062	2.9569
Newton, Middlesex County, Mass	5,385	1.9867	4.3566	2.6813	4.9996
Chevy Chase, Montgomery County, Md	8,567	.1972	1.8106	2.2383	5.9202
Bloomfield Hills, Oakland County, Mich	20,496	.8075	1.6759	1.5796	2.8866
Webster Groves, St. Louis County, Mo	4,344	2.1026	2.4330	4.3701	5.2996
Westfield, Union County, N.J	5,658	1.5058	1.5993	3.0876	3.4117

TABLE 3.—ALLOCATIONS TO WEALTHY SUBURBAN COMMUNITIES'—Continued

	Per capita income	Per Capita city allocation IFTF formula	Per Capita city allocation Current formula	City and county IFTF formula	Prorated share current formula
Scarsdale, Westchester County, N.Y.	11,293	.8233	2.1426	2.8353	4.0487
Hudson, Summit County, Ohio	5,172	1.3218	2.0450	2.9294	3.8714
Shaker Heights, Cuyahoga County, Ohio	8,101	.8703	1.3317	3.3071	4.0243
Upper Arlington, Franklin County, Ohio	6,228	.7592	1.3317	2.2510	3.0197
Lower Merion, Montgomery County, Pa	7,401	1.1602	2.1017	1.8824	3.1675
Highland Park, Dallas County, Tex	9,402	.8423	1.4679	1.9310	2.6202
Bellevue, King County, Wash	4,540	1.5735	2.9939	3.0011	5.5167

TABLE 4.—ALLOCATIONS TO INDUSTRIAL ENCLAVES AND RESORT AREAS

City, State: County	IFTF formula per capita share	Current formula per capita share
Commerce City, Calif.: Los Angeles	10.0237	13.4877
Industry City, Calif.: Los Angeles	9.9102	13.4872
Irwindale, Calif.: Los Angeles	10.0036	13.4872
Vail, Colo.: Eagle	7.6324	11.8636
Bethany Beach, Dela.: Sussex	9.4762	14.0952
Fenwick Island, Del.: Sussex	9.4762	14.0893
Ocean City, Md.: Worcester	2.8287	13.1266
Teterburg, N.J.: Bergen	3.0103	11.1579
Dering Harbor, N.Y.: Suffolk	6.0073	15.5417
Ocean Beach, N.Y.: Suffolk	6.0073	15.5321
Seltaire, N.Y.: Suffolk	6.0073	15.5405

TABLE 5.—ALLOCATIONS TO COUNTY AREAS WITH SIMILAR PER CAPITA INCOMES AND TAX EFFORTS

	Per capita income	Tax effort	County area per capita allocation IFTF	County area per capita allocation Current	County area and State per capita allocation IFTF	County area and State per capita allocation Current
Mobile, Ala	2,403	0.75	9.27	12.43	16.72	16.78
Coconino, Ariz	2,405	.76	8.96	10.09	15.90	14.78
Osceola, Fla	2,423	.73	9.01	9.79	15.27	13.37
Adams, Iowa	2,409	.75	9.51	11.53	14.98	15.95
Somerset, Maine	2,367	.78	9.79	10.34	16.57	15.67
Dodge, Minn	2,373	.75	9.82	12.61	16.62	17.24
Merrick, Nebr	2,391	.76	9.93	10.93	14.23	15.26
Griggs, N. Dak	2,371	.76	9.96	15.10	16.93	21.05
Yankton, S. Dak	2,421	.75	8.99	9.73	14.47	15.73
Barron, Wis	2,452	.72	9.01	12.67	16.38	17.66
Range of allocations			1.00	5.40	2.70	7.70
Standard deviation of allocations			.42	1.70	1.00	2.06

Chairman BOLLING. Next, Steve Rohde, Center for National Policy Review.

STATEMENT OF STEVEN M. ROHDE, CENTER FOR NATIONAL POLICY REVIEW, CATHOLIC UNIVERSITY LAW SCHOOL, WASHINGTON, D.C.

Mr. ROHDE. Thank you, Mr. Chairman.

I would like to submit my full prepared remarks for the record, and summarize them.

Chairman BOLLING. It will be included.

Mr. ROHDE. I am a research associate with the Center for National Policy Review, which is a legal and social science research and resource group, based at Catholic University, and concerned with civil rights and urban problems. I am delighted to have the opportunity to testify before this subcommittee on the research I have been engaged in. For the record, I would like to state this research was not financed by the National Science Foundation, but by the Rockefeller Brothers Fund. I guess I am an exception on this panel.

Our allocation study has focused on the question of how well the statutory formula and possible alternative formulas distribute revenue sharing dollars in accordance with the needs of jurisdictions, with particular emphasis on the extent to which the formula allocates funds commensurate with the needs of jurisdictions with relatively large numbers of minorities and poor people, and the extent to which it distributes funds in accordance with the needs of this Nation's central cities. While some refinement of our analysis is still needed, the basic thrust of our findings are clear. What I would like to do is give an overview of some of the key conclusions and policy recommendations flowing out of our study, and then go into a little bit more detail on some of the really important points.

First, an important inference to be drawn from our results is that the current statutory formula is not doing an adequate job in allocating in accordance with need, and that this inadequacy has a discriminatory impact upon minorities and the poor, and particularly against those who are both minority and poor. There is also a serious question as to whether the formula is allocating funds commensurate with the needs of the central cities.

Two, sharply increasing the maximum per capita limit on local entitlements and eliminating the 20-percent minimum by themselves would have some positive impact on the cities and on jurisdictions with relatively large numbers of minority and poor people. But this is really only the tip of the iceberg. Much more fundamental changes are needed in the formula, if it is to meet the stated objective, "to put the money where the needs are."

Three, per capita income is a particularly poor measure of need in the formula and should be replaced by the concept of percent below the poverty level.

Four, even percent below the poverty level does not adequately measure needs in the central cities. Thus, some special method of aiding cities should be included in the formula. One way this could be done is by setting aside a separate pot to give explicit bonuses to cities. Our research has indicated a possibly more promising method, which is to formulate an adjusted poverty definition which builds in extra weight, say 150 percent of poverty, for cities, to take into account such factors as the understatement of poverty in the cities due to higher cost of living, the fact that cities have higher costs of providing services, and the fact that there are certain extra services which are generally associated with the phenomenon of urbanization and the problems of our core cities and densely settled populations.

Five, by changing the definition of tax effort to employ a definition of fiscal capacity as including only income above the poverty level, as opposed to all income, the distortive effects of the present tax effort factor with respect to need can be lessened and minorities and the poor can be helped.

Six, while combining adjusted poverty multiplicatively with the altered definition of the tax effort in the intrastate formula would work very well for minorities, poor, and the cities; the multiplicative nature of the formula would continue to result in distortions limiting the overall efficiency of the formula in minimizing deviations from need. This problem can be addressed by distributing 50 or 60 percent of the funds on the basis of the multiplicative combination, and distributing the remainder solely on the basis of our adjusted poverty concept.

Finally, if the allocation to local areas is to continue to be influenced by an initial allocation to State areas, as opposed to a kind of pooling arrangement which was discussed in the Institute for the Future Study, it is critical that the interstate formula be revised to more adequately reflect the need. The revision of the interstate formula is also important in its own right, because it determines the allocation to State governments. Among the major problems with the interstate formula are the use of per capita income instead of percent poverty in both three- and five-factor formulas, and the fact that tax incentive factors in the five-factor formula are combined in an additive fashion, as opposed to a multiplicative fashion with the other factors in the five-factor formula; we found that this has had distributional effects.

I think probably the single most important issue with policy implications in our study is the question of per capita income versus percent poverty as a fundamental measure of need. On its face, the use of per capita income may seem logical, since low income is an important aspect of need. However, the needs for public services caused by the existence of low-income inhabitants of a jurisdiction could also be measured, as has been pointed out, more directly by a variable such as percent of persons below the poverty level. At first glance it might seem that it makes relatively little difference which of these two measures is used, since there is a fairly high correlation between the percent of poverty and low per capita income. Yet for a number of reasons, it turns out that the issue is really of very great importance.

One of the clear findings of our study is that the use of per capita income instead of percent poverty as a measure of need has a sharp discriminatory effect on minorities, on the poor, and especially on those who are both minority and poor. At the local level, it also has a discriminatory effect against the cities. Given these effects, per capita income should only be used over percent poverty if it can be shown to be clearly superior as a measure of need. To the contrary, however, the following analysis which I will go into, points in the other direction, that percent poverty is far superior to per capita income as a measure of need.

One problem with per capita income is that at the local level, its relative variation about its mean is relatively low, so that it fails to sufficiently distinguish between jurisdictions. One consequence of this low relative variation of per capita income is that in the multiplicative three-factor formula, in practice the tax effort factor, which has a much higher relative variation, has a much more important effect in determining per capita allocations, and the effects of per capita income are submerged. By contrast, the relative variation of percent below the poverty level is almost identically equal to that of tax effort, so its effects would not be submerged in the formula if percent below the poverty level were used.

While the problem associated with the relatively low variations in per capita income could conceivably be corrected by expressing variables in some form of standard score, the deficiencies of per capita income as a measure of need are much more fundamental. One important element of need relates to the cost of providing a given basket of services. While percent below the poverty level is insensitive as a measure of this aspect of need, it is far superior to per capita income, which actually works in the reverse direction, since jurisdictions where the cost of providing services is high would tend to have a relatively high per capita income, given that prevailing wage rates are an important determinant of cost of providing public services.

With respect to the need for public services, many jurisdictions have relatively large numbers of poor persons, with high needs for public services, while at the same time having a per capita income close to or even in some cases, above average. For these jurisdictions, which include among others, some of our largest cities, per capita income is insensitive as a measure of needs attributable to poverty.

Looked at in a broad context, the number of areas of unmet service needs are so diverse that it is unrealistic to expect any one variable such as either per capita income or percent poverty to accurately reflect all of these needs. What we really are attempting to do, then, for inclusion in a revenue sharing formula, is to come up with a simplified rough proxy of need, since both in terms of data base problems and political feasibility, it does not seem very practical to use a need index based on, say, 10 or 20 variables, in a formula to allocate funds to 38,000 jurisdictions.

To assist in answering questions as to what variable or combination could be used as a rough proxy, we did include in our data base a large number of variables which can be justified as being related to the need for one or more public services.

Simple correlations were computed between percent poverty and each of these variables, and also between per capita income and each of these variables in order to develop some basis for evaluating percent poverty and per capita income as rough proxies. In the great majority of cases, percent poverty seems to be a much better proxy than per capita income.

Chairman Bolling. That seems a good place to ask you to stop; we will include your full statement for the record.

[The prepared statement of Mr. Rohde follows:]

Prepared Statement of Steven M. Rohde

Mr. Chairman and members of the subcommittee; my name is Steven M. Rohde. I am a Research Associate with the Center for National Policy Review, a legal and social science research and resource group based at Catholic University and concerned with civil rights and urban problems. I am delighted to have the opportunity to testify before the Subcommittee on the research I have been engaged in on the General Revenue Sharing allocation formula. The research has been financed by a grant from the Rockefeller Brothers Fund.

The Center's allocation study has focused on the question of how well the statutory formula and possible alternative formulae distribute revenue sharing dollars in accordance with the needs of jurisdictions, with particular emphasis on the extent to which the formula allocates funds commensurate with the needs of jurisdictions with relatively large numbers of minorities and poor people, and the extent to which it distributes funds in accordance with the needs of the nation's central cities. During the course of the study, in addition to performing general statistical analyses, we have simulated the effects of over

300 formulae which allocate funds across the 3136 county areas competing with each other, of over 900 possible interstate formulae, and almost 400 formulae which combine selected interstate formulae with selected intrastate formulae, utilizing two different methods of determining the State-local split. Because of time and resource limitations, it was decided to keep the simulations of intrastate formulae to county area aggregates. We anticipate that the basic thrust of the findings would hold true if the same formulae were also used for intra county allocations, although this has to be considered a subject for future research.

While some refinement of our analysis is still needed, the basic thrust of the findings are clear. What I propose to do in this statement is to provide background on the framework of our analysis, and to highlight some of the important findings and discuss policy implications. I would be happy to answer any questions relating to details and results of our study and to submit additional materials for the record. Of course, a copy of our final report will also be forwarded to the Subcommittee.

Let me say at the outset that an important inference to be drawn from our results is that the current statutory formula is not doing an adequate job in allocating according to need, and that this inadequacy has a discriminatory impact upon minorities and the poor, and particularly against those who are both minority and poor. Thus if the revenue sharing program is to be renewed by the Congress, major revisions in the formula are necessary.

Some of the key conclusions and policy recommendations on which I will elaborate are the following:

(1) Per capita income is a particularly poor measure of need in the formula, and should be replaced by the concept of percent below the poverty level.

(2) Even percent below the poverty level does not adequately measure needs in the central cities. Thus some special method of aiding cities should be included in the formula. This could be done by setting aside a separate pot to give explicit bonuses to cities, or by formulating an "adjusted poverty" definition which builds in an extra weight for cities to take into account higher cost of living, higher cost of providing service, and additional special needs of the cities.

(3) By changing the definition of tax effort to employ a definition of fiscal capacity as including only income above the poverty level, as opposed to all income, the distortive effects of the present tax effort factor with respect to need can be lessened, and minorities and the poor can be helped.

(4) While combining adjusted poverty multiplicatively with the altered definition of the tax effort in the intrastate formula would work very well for minorities, poor and the cities, the multiplicative nature of the formula would continue to result in distortions limiting the overall efficiency of the formula in minimizing deviations from need. This problem can be addressed by distributing only 50%–60% of the funds on the basis of the multiplicative combination, and distributing the remainder solely on the basis of adjusted poverty.

(5) If the allocation to local areas is to continue to be influenced by an initial allocation to "state areas", it is critical that the current interstate formula be revised to more adequately reflect need. Revision of the interstate formula is also important in its own right, because it determines the allocation to state governments.

The Joint Committee on Internal Revenue Taxation has described the key purpose of the revenue sharing allocation formula as putting "the money where the needs are." However, due to inadequacies in available data and the time constraints under which the final formula was worked out in the legislative process, members of Congress and relevant Committee staff faced serious limitations in their capacity to assess the extent to which the formula would meet the objectives of Congress. One goal of our allocation study, therefore, has been to help close this research gap.

In evaluating the extent to which the formula is successful in "putting the money where the needs are," it was deemed essential to develop measures or proxies of need. This is an extremely difficult process, involving a significant amount of subjectivity. Nevertheless, guidance concerning the general notions of the Congress concerning need can be gotten from an examination of the legislative history of the Act.

A reading of the reports of the House Committee of Ways and Means and the Senate Committee on Finance as well as the "General Explanation of the State and Local Assistance Act" prepared by the staff of the Joint Committee on Internal Revenue Taxation, reveals two distinct aspects of need repeatedly referred to and discussed. These are: (1) needs caused by the existence of low income inhabitants of jurisdictions, and (2) special needs relating to the phenomenon of urbanization and the problems of our core cities. Our measures of need are therefore based on these two aspects.

DEFICIENCIES OF PER CAPITA INCOME AS THE BASIC MEASURE OF NEED

Because of the extremely large diversity in the size of local jurisdictions, population is a logical data element to be combined multiplicatively with other elements in determining total dollar allocations. But if the allocations to jurisdictions are conceptualized in per capita terms, per capita income can be thought of as the basic measure of need used in the allocation formula, with the lower the income the higher the need.

On its face, the use of per capita income may seem logical, since low income is an important aspect of need. However, the needs for public services caused by the existence of low income inhabitants of a jurisdiction can be measured more directly by a variable such as percent of persons below the poverty level. At first glance it might seem that it makes relatively little difference which of these two measures is used, since there is a fairly high correlation between percent poverty and low per capita income. Yet for a number of reasons it turns out that the issue is of great importance.

As I will illustrate in more detail later, the use of per capita income instead of percent poverty as a measure of need has a sharp discriminatory effect on minorities, on the poor, and especially on those who are both minority and poor. At the local level, it also has a discriminatory effect against the cities. Given these effects, per capita income should only be used over percent poverty if it can be shown to be clearly superior as a measure of need. To the contrary, however, the following analysis points in the other direction—that percent poverty is far superior to per capita income as a measure of need.

One problem with per capita income is that at the local level its relative variation about its mean is relatively low, so that it fails to sufficiently distinguish between jurisdictions. One consequence of the low relative variation of per capita income is that in the multiplicative three factor formula, in practice the tax effort factor, which has a much higher relative variation, has a much more important effect in determining per capita allocations, and the effects of per capita income are submerged. By contrast the relative variation of "percent below the poverty level" is equal to that of tax effort, so its effects would not be submerged. (For the 3,136 county areas in the country the respective coefficients of variation, defined as the standard deviation divided by the mean, are .24 for per capita income, .62 for tax effort, and .62 for percent of persons in families below the poverty level.)

While the problem associated with the relatively low variations in per capita income could conceivably be corrected by expressing variables in some form of standard score, the deficiencies of per capita income as a measure of need are really much more fundamental. One important element of need relates to the cost of providing a given basket of services. While percent below the poverty level is insensitive as a measure of this aspect of need, it is far superior to per capita income, which actually works in the reverse direction, since jurisdictions where the cost of providing services is high would tend to have a relatively high per capita income, given that prevailing wage rates are an important determinant of cost of providing public services.

With respect to the need for public services, many jurisdictions have relatively large numbers of poor persons, with high needs for public services, while at the same time having a per capita income close to or even above average. For these jurisdictions, which include, among others, some of our largest cities, per capita income is insensitive as a measure of needs attributable to poverty.

Looked at in a broad context, the number of areas of unmet service needs are so diverse that it is unrealistic to expect any one variable such as per capita income or percent poverty to accurately reflect all of these needs. To really measure these needs, it would be necessary to define every specific category of service need, to identify specific variables which can be justified as closely related to these specific service needs, and then to combine these variables with appropriate weights into an overall index.

We did not attempt this complicated task. Instead we attempted to come up with simpler need measures which would serve as rough proxies for the complex of service related variables. As far as specific inclusion in a revenue sharing formula is concerned, all that one could reasonably hope to do anyway would be to come up with a simplified rough proxy or proxies for need, since both in terms of data base problems and political feasibility, it does not seem very practical to use a need index based on, say 10 or 20 variables, in a formula to allocate funds to 38,000 jurisdictions.

To assist in answering questions as to what variable or combination of variables could be used as rough proxies for need, we did include in our data base a large number of variables which can be justified as being related to the need for one or more specific public services. Among these variables are the percent of the population living in overcrowded units, the percent living in units lacking one or more plumbing facilities, the percent living in units which are both overcrowded and lacking plumbing, the percent of units which are renter occupied, population density, the crime rate, the unemployment rate, the percent of the over 25 population which did not complete high school, the percent of families where there is no male spouse present, the percent of the population consisting of children under the age of 18, the birth rate, the percent of the population consisting of persons over the age of 65, the percent of the population who are both poor and over the age of 65, the death rate, the infant mortality rate, the venereal disease rate, and the percentage of the population living in central cities.

Simple correlations were computed between percent poverty and each of these variables and between per capita income and each of these variables in order to develop some basis for evaluating percent poverty and per capita income as rough proxies of need. In a great majority of cases, percent poverty seems to be a better proxy than per capita income, and this situation tends to hold up not only when the geographic level is varied but also when the correlations are computed by case weighting by population instead of giving each jurisdiction an equal weight.

I have had an opportunity to examine the just completed report by the Institute for the Future entitled *An Alternative Approach to General Revenue Sharing: A Needs-Based Allocation Formula.* I commend the investigators in the Institute for the Future study for their efforts to develop a service requirements index for inclusion in an evaluation index of alternative revenue sharing formulae. Although I have not had the opportunity to review their methodology in any detail, including their factor analysis approach, I was particularly struck by one aspect of their results which I think illustrates the inherent weakness of per capita income as a proxy for need.

The investigators used the service requirements index to develop a sophisticated method of including per capita income in their alternative formula in exponential form. But in spite of these efforts, the correlation between allocations in their final recommended formula and their own evaluation index was a remarkably low .4346 for local governments, meaning that less than 19% of the variation in allocations can be "accounted for", or "predicted from" the evaluation index. By attempting to "fit" per capita income to the service requirements index, rather than using other variables which might be a better proxy, the investigators placed themselves in a straightjacket which even sophisticated statistical methods could not overcome.

SPECIAL NEEDS IN THE CENTRAL CITIES

Although % poverty clearly seems to be superior to per capita income as a measure of need, for a number of reasons % poverty, by itself, does not adequately reflect needs of the central cities. Because % poverty does not take into account variations in the cost of living (except for the rural farm population), % poverty understates real poverty in the central cities. In addition it does not take into account the higher cost of providing services in the cities. Nor does it reflect extra services generally associated with the phenomenon of urbanization and the problems of core cities and densely settled population. services such as pollution control, increased police protection, and refuse disposal. There is also the special problem that central cities are often called upon to provide services for nonresidents who live in the metropolitan areas.

Many of these special problems were specifically referred to in the Congressional Committee Reports, and it therefore seems consistent with the objectives of Congress to take these extra needs into account in a need measure designed to evaluate the performance of revenue sharing formulae. Since using any particular method of including this component could be considered somewhat arbitrary, six such measures were developed for purposes of evaluating the statutory formula and various possible alternatives. (For comparison purposes, % poverty by itself was retained as a seventh need measure.)

In order to allow for direct comparison with various formulae, the need measures were expressed in dollar terms based on the same fixed amount of funds available in the six month first entitlement period used for the study. For three of the need measures a separate pot was set up based on the variable "% of county area population living in a central cities", and this pot was combined additively with a separate pot based on % poverty. (The only variation in these three need measures were in the weights, 3 to 1 for % poverty in one case, 6 to 1 in a second, and 9 to 1 in a third. The weights were chosen to favor % poverty in part because of the significantly greater relative variation of % central city, which causes it to have a greater influence on the need measures than it might appear at first glance.)

Two of the other need measures were based on a proxy for an "adjusted poverty" concept, with persons in central cities or urbanized areas counted as poor if they are below 125% of the poverty level. The final need measure was based on poverty weighted three times in one pot and a separate pot determined by a county area's score on "% urbanized multiplied by % poverty."

When the correlations between these need measures and specific service related variables at the county area level are compared with the correlations between the service related variables and % poverty, it is found that for the most part, these new need measures tend to have better overall balance as a proxy, although in some cases the actual correlations with specific variables are lower.

Finally since the need measures were designed to evaluate county area allocations across all 3.136 county areas in the country, the question of interstate variatioins in state vs. local functions had to be faced. Since the revenue sharing law provides for a uniform one third, two thirds split between state and local governments, on the one hand it would seem legitimate to disregard such variations. However, since there is considerable logic to the argument that interstate variations in functions performed at different levels of government affect the need of governments for revenue sharing funds. six new need measures were developed for county areas based on a multiplication of the original need measure times a factor consisting of county area adjusted taxes for all county areas in the state divided by total state and local taxes for the state. Thus we ended up with 12 separate need measures for county areas, six of them taking into account functional variations between states.

One method used in the study for evaluating the statutory formula and alternative formulae against these need measures was to sum up, over the 3,136 county areas, the dollar deviations from need, ignoring the signs. (If signs were not ignored, the sum would always be zero, given the fixed pot of funds.)

PERFORMANCE OF FORMULA WITH RESPECT TO TARGET POPULATIONS AND COMPARISON WITH PERFORMANCE OF NEED MEASURES

One clear limitation of the allocation study is that it only measures allocations to jurisdictions—not to people. Obviously in the end it may be of little benefit for minorities to allocate funds to a jurisdiction with a large number of minorities if minorities are discriminated against in the use of the funds. This of course is a serious problem, but I considered it to be outside the scope of the allocation study. Thus for the purpose of evaluating the implications of the statutory formula and various possible alternative formulae on specific target subpopulations, I assumed no intercounty differences in the way benefits are distributed to a given subgroup. If one assumes that target subpopulations derive benefits from revenue sharing dollars in proportion to their numbers in the total population of the county area, for the purposes of evaluation one can assign a total number of dollars going to a target subpopulation under any given formula. For convenience the total dollars going to the subpopulation can be divided by the total number of people in the subpopulation to yield a theoretical per capita allocation going to the subpopulation. (Mathematically this process is identical to computing a weighted average of per capita allocations going to county areas under a particular formula, weighting by the number of persons in the subpopulation for each county area.)

The statutory formula and various alternative formulae were evaluated in terms of the following six target subpopulations: minorities (not including Spanish whites), minorities (including Spanish whites), poor persons in families, minority poor persons in families (not including poor Spanish whites), minority poor persons in families (including poor Spanish whites), and central city residents.

For the six month first entitlement period, the per capita allocation going to all units of government below the state totaled $8.60. Two-thirds of the state area amount totaled $8.64, the difference representing the per capita amount lost by county areas to state governments as a result of application of the 50% rule to county governments. Since my county area simulations of alternative formulae and need measures did not apply any 50% rule, the per capita amounts for the statutory formula were scaled up for comparison purposes to bring the total per capita amount to $8.64.

MINORITIES

By use of the weighted average approach previously described, the per capita county area allocations to minorities under the statutory formula were computed to be $9.60 for the six month first entitlement period. While this indeed is more than the overall $8.64 per capita, if funds were allocated solely on the basis of each of the 12 need measures used for evaluation purposes, the per capita allocations to minorities would in every case be substantially higher, ranging from $11.15 to $11.71. Thus if any one of the 12 need measures is assumed to be appropriate, minorities are being significantly shortchanged by the allocation formula.

If Spanish whites are included in the definition of minority, the per capita county area allocation under the statutory formula is $9.66. The per capita allocations under the 12 need measures range from $11.28 to $11.84. Thus a similar pattern holds true.

POOR PERSONS

The per capita allocation to poor persons in families is $9.19. Per capita allocations to poor persons in families under the 12 need measures range from $10.88 to $12.49. Thus compared with any of the 12 measures of need, poor persons do very poorly under the statutory formula.

MINORITY POOR PERSONS

The per capita allocation to minority poor persons in families is $9.86. Under the 12 measures of need, the per capita allocations to such persons ranges from a low of $12.60 to a high of $14.86. This represents an extremely serious deficiency in the statutory formula, since it means that the formula is particularly weak in allocating funds towards jurisdictions containing those people who traditionally have been most disadvantaged, the minority poor.

If poor Spanish whites are included in the definition of minority poor, the statutory formula fares just as poorly—the per capita allocation to the minority poor is $9.88 for the six month first entitlement period, while allocations under the 12 need measures range from $13.11 to $14.77.

CENTRAL CITY RESIDENTS

Central city residents are the only target subpopulation studied where the question of whether funds are being allocated in a manner commensurate with need appears to be even a close question. The per capita allocation to central city residents is $9.67, whereas if allocations were made solely on the basis of the 12 need measures the range would be from $9.15 to $11.64. Thus here it depends on which need measure one thinks is most appropriate. However for 8 of the 12 need measures, the per capita allocation exceeds $10. This is true of all six need measurse which take into account interstate variations in functions performed at the local level.

To summarize, it must be admitted that there is a considerable degree of subjectivity in evaluating whether a particular need measure is appropriate. But unless all 12 need measures are way off base, then it must be concluded that the statutory formula is seriously shortchanging minorities, the poor, and especially the minority poor. And if any one of eight of the 12 need measures is considered to be appropriate, then the central cities are being shortchanged as well.

The rest of my statement deals primarily with the effects of possible modifications in the formula to correct these deficiencies.

THE LIMITS

Much attention has been focused on the formula rules which set a ceiling on the allocations to county areas, municipalities, and townships at 145% of the per capita local share going to all units of local government within the state, and which set a floor equal to 20% of the per capita local share for the state. Both our statistical analysis of individual limits and our simulation of the formula with all limits removed (including removal of the 50% rule) confirm the fact that the net effect of the limits is to hurt all of the target populations. Removal of the limits increases the per capita allocation to minorities (not including Spanish whies), by $.43, from $9.60 to $10.03. With Spanish whites included the gain from removal of the limits is $.42, from $9.66 to $10.08.

For poor persons, the net gain is $.36, from $9.19 to $9.55. For minority poor persons (not including poor Spanish whites), the gain is $.52, from $9.86 to $10.38. With poor Spanish whites included, the gain is $.64, from $9.89 to $10.53. Finally, for central cities, the gain is $.30, from $9.67 to $9.97.

It should be clear from these figures, however, that the limits are only the tip of the iceberg. While useful, the gains accruing to the target subpopulations from removal of the limits are relatively minor compared to the $2, $3, $4 and even $5 per capita gains needed to bring the target subpopulations up to a level commensurate with their needs.

In addition, although removal of the limits helps the target subpopulations, it does little to reduce overall deviations from need as measured by summing up the absolute values of the deviations from need (in other words, dropping the sign) over all county areas.

Finally, although there seems to be no rational justification for any minimum limit, results from our study suggest that depending on the particular alternative formula selected, some maximum upper limit could be useful to avoid extreme results caused by combining factors in a multiplicative fashion. However, depending on the particular formula, such a maximum would probably be in the neighborhood of 600% to 700%.

SUBSTITUTING PERCENT POVERTY FOR PER CAPITA INCOME

Probably the single most significant change that could be made in the intrastate allocation formula would be to substitute % poverty for the inverse of per capita income as a measure of need. The following description of the magnitude of the benefits is based on a comparison of formulae based on a competition among all county areas competing with each other, and without applying limits. Thus if the current interstate formula and limits were retained, the benefits would be substantially reduced.

However, given the assumptions described, the benefit to minorities of the substitution of % poverty is $2.28 per capita if Spanish whites are not included and $2.38 if Spanish whites are included. For poor persons the increase is $2.21. For minority poor, the increase is $3.89 if poor Spanish whites are not included and $4.14 if poor Spanish whites are included. Finally for the central cities, the increase is an even $1.00 per capita.

Before leaving the question of % poverty vs. per capita income, I would like to comment on the just completed report of the Stanford Research Institute entitled *General Revenue Sharing Formula Alernatives* wherein % poverty was specifically considered and rejected as a substitute for per capita income. Several reasons were cited for this rejection. One is that in Massachusetts it was noted that there was greater clustering of % poverty figures around the state mean. This is indeed perplexing, since as I have already stated, at the county area level, the relative variation of % poverty about its mean is indeed much greater than it is for per capita income. And although I haven't checked this in detail, I believe that for every state, or at least almost every state, the same pattern holds at the county area level within the state. In Massachusetts for example, the mean unweighted county area per capita income is $3266 and the standard deviation is only $278, a standard deviation to mean ratio of less than one tenth. For % of persons in families below the poverty level, the mean is 6.66% and the standard deviation is 2.38%, a standard deviation to mean ratio of greater than one third. I would be very surprised if across the country generally, the entire pattern of these relationships were reversed at the municipality and township level.

A second problem noted by the Standard Research Institute is that the below poverty data definition also includes students living off campus or in nongroup quarters. The S.R.I. report suggests that this overstates poverty in places like Berkeley, California and Cambridge, Massachusetts. Although I seriously doubt whether this would be a serious problem on a national basis, if it is perceived to be a problem it could easily be resolved by using the variable "% of persons in families below the poverty level", which indeed is the precise definition of % poverty we happened to select for use in our own study.

Third, it is suggested that percent below the poverty line does not work well in "rural counties or places where nearly everyone is poor, but few are below the poverty line." However, since the correlation between % below the poverty level and % below 125% of the poverty level is extremely high, on the order of .99, I seriously doubt whether this could be a significant problem.

Finally the S.R.I. study criticizes percent below the poverty level for its treatment of very wealthy communities which nevertheless have some people below the poverty level. Beverly Hills is cited as an example. Poor persons in such communities do have needs, but of course such communities have great capacity to meet those needs because of their high incomes.

This aspect of need relates to fiscal capacity, but I am not suggesting that % poverty be used as a measure of fiscal capacity. Indeed, as I will discuss shortly, the measure of fiscal capacity that we recommend in our study focuses directly on income above the poverty level, which would work even more to the detriment of Beverly Hills than the current use of all income as a measure of fiscal capacity in the denominator of tax effort.

It is of course possible to include a separate measure of fiscal capacity is one element of an overall need measure, but in view of the fact that a measure of fiscal capacity is included in the denominator of the tax effort factor, adding such a factor to the need measure in addition to % poverty is probably an unnecessary complication.

TAX EFFORT

While it can be argued that eliminating tax effort from the allocation formula would simplify allocations based on need, there do seem to be some potentially useful features of a tax effort factor in a revenue sharing formula. One is a potential incentive effect, to encourage local governments to increase their effort, or at least to discourage them from sharply reducing taxes. Another aspect of the tax effort factor is that it to some extent deals with the thorny problem of variations in functions of governments.

Third, to the extent that tax effort can be thought of as tax burden, using tax effort as a factor can provide extra assistance to those jurisdictions whose residents are undergoing heavy burdens.

Finally, as I have already noted, because the measure of fiscal capacity used in the denominator of tax effort can also be considered an aspect of need, inclusion of this factor probably lessens any need to include in the basic need measure used in the formula a separate element to distinguish fiscal capacity needs from service requirements and cost of services needs.

In any event, I have taken for the purpose of our study the notion that inclusion of a tax effort factor is desired by the Congress, and therefore have not seriously considered dropping tax effort. Nevertheless, it is clear that there are many possible definitions of tax effort, and I have therefore experimented with various alternative definitions in an attempt to come up with one capable of meeting the incentive effects and other effects desired by Congress while at the same time being least disruptive of the basic objective of "putting the money where the needs are."

The concept of tax effort has existed well before the advent of the revenue sharing program. Within the basic concept of a measure of performance divided by a measure of capacity to perform, there are many possible variations. One issue related to capacity is whether measure of capacity should be implicitly progressive, proportional or regressive in its definition of the tax capacity. In his textbook on public finance, Bernard Herber suggests a measure which makes an inherently progressive assumption in measuring fiscal capacity, with tax effort defined as per capita taxes raised divided by per capita income, divided again by per capita income. (Mathematically, this reduced to per capita taxes, divided by per capita income squared.) In other words, to have the same effort, a wealthier jurisdiction would have to have a higher ratio of taxes raised to personal income.

Still another possible measure is to divide local taxes raised by Federal income taxes paid. This also builds the somewhat progressive Federal income tax into the measure of capacity.

The measure of capacity used in the current revenue sharing program assumes neither progressively nor regressively, but instead assumes that equal efforts mean taxes raised directly proportional to income. However use of the property tax base as a measure of capacity, as has been suggested by the Brookings study, builds an inherently regressive structure into the definition of what constitutes equal efforts.

If measurement of "tax burden" is one of the goals of the tax effort factor in revenue sharing, I question whether a regressive assumption is appropriate, in spite of the fact that the property tax is the dominant tax now in use at the local level. There is no need to accept regressivity in developing a measure of tax effort for use in a revenue sharing formula.

In an article in the March 1970 issue of the *National Tax Journal* entitled "Aid to State and Local Governments," Lester Thurow pointed out that tax effort, as generally measured by using all personal income as a measure of capacity, "ignores the federal government poverty line, a line which specifies the minimum private income which each individual should receive. Consequently, effort should be measured in terms of tax collections per dollar of income above the poverty line."

For the purposes of our study, Thurow's concept of tax effort was defined by dividing the per capita adjusted taxes of a county area by a value "per capita income minus $1,000". The figure $1,000 was selected because as of 1970, the date corresponding to the census data on per capita income, the poverty level was $3,960 for a family of four, or approximately $1,000 per capita. However to avoid extreme variations as per capita income of a jurisdiction got close to $1,000, a minimum floor of $500 was set for the denominator.

Data base problems prevented a full test of a large number of possible measures of tax effort in our study, particularly at the county area level. Nevertheless one significant finding was that if the definition of tax effort is changed by using the Thurow concept, with the refinements I have mentioned, there is a uniform lessening in deviations from need compared to what happens when the current statutory definition is used. In addition, all of the target subpopulations are significantly helped, except for the ciites, which are hurt by the substitution, but not in a major way.

ADJUSTED POVERTY

If % poverty is combined multiplicatively with the altered definition of tax effort, the cities still are worse than they would based strictly on a number of the measures of need. This again relates back to the problem that % poverty alone is not an adequate measure of need in the cities. On the basis of a number of simulations, it appears that the best approach we have found is to account for the special needs of the cities by weighting poverty in the cities by 140% or 150%. This approach helps the cities without bringing the poor person target subpopulation below its need level. It also is somewhat beneficial to minorities.

COMBINING THE MULTIPLICATIVE AND ADDITIVE APPROACHES

The one remaining serious problem with the modified county area formula as described in that allocating all of the funds according to a multiplicative formula results in distortions and overall deviations from need not significantly reduced from the current statutory formula. Although the deviations are no longer in a direction so as to hurt the target subpopulations, they still constitute a defect in the formula. The problem can not be solved by switching to a pure additive formula, since the inclusion of the tax effort factor by itself as one component of an additive formula has a very serious negative effect on the target subpopulations. However, by combining multiplicative and additive principals, we found that overall deviations from need could be sharply reduced in a manner which allows the target subpopulations to continue to do well. The method is to limit the multiplicative portion to 50% or 60% of the total pot of funds, with the remainder allocated on a more direct need basis. For example, if adjusted poverty (defined by weighing poverty by 150% in the central cities) multiplied by the Thurow measure of tax effort takes up 50% of the pot, and if the other 50% is allocated on the basis of adjusted poverty alone, the target subpopulations fare as follows:

The per capita allocation to minorities is $12.44 if Spanish whites are not included, and $12.65 if Spanish whites are included. The per capita allocation to poor persons is $12.40. The per capita allocation to minority poor persons is $15.05 if poor Spanish whites are not included, and $15.68 if they are included. The per capita allocation to the central cities is $10.90. In every case these allocations seem generally consistent with or even better than the range of allocations according to need measures.

THE PROBLEM OF ALLOCATING TO STATE AREAS

The final topic which I would like to briefly discuss is a major one which will be treated thoroughly in our final report. The results I have just described are still based on all county areas in the country competing directly with each other, without any initial distribution to state areas. However we have run simulations which reveal that even by using a preferred county area allocation, the distributional pattern will still be unfavorable if no changes are made in the interstate formula and if that formula continues to be used as the basis for determining the state area pot for the intrastate formula. The overall deviations from need will not be significantly reduced from the current statutory formula and the poor and the minority poor will still fare relatively poorly.

Our analysis has also revealed deficiencies in the interstate formula as it applies to state governments, stemming primarily from the use of per capita income instead of % poverty in both the 3 and 5 factor formulae, and also because the tax incentive measures in the 5 factor formula are combined additively with the other factors.

CONCLUDING REMARKS

The issues posed by the revenue sharing allocation formula are indeed complex and often highly technical. But their complexities do not detract from the importance of the issues in real human terms. It is critical that the Congress take a hard look at the issues, and if the program is to be renewed, demonstrate a willingness to make the substantial revisions in the formula necessary to successfully meet the principal objective "to put the money where the needs are."

Chairman BOLLING. Next, I am going to call on a man whom I talk with relatively infrequently, but when I do, the emergency to me is of great proportions. When I confront an issue that I find it virtually impossible for me to put the time into reasoning it through and I have to come up with a quick conclusion, I want to find somebody who is both highly expert and eloquent and completely committed to the public service. I call on Mr. Pechman. I do not even know that he knows how much I value his advice, because I do not call on him very frequently, not finding myself in such desperate circumstances too often, fortunately.

Joe, I would like very much for you to comment on this very interesting set of statements and give us some guidance as to what it all means, in terms of what the Congress will presumably do sometime in this Congress.

STATEMENT OF JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. PECHMAN. Thank you very much for your kind words, Mr. Bolling.

It is certainly a privilege to appear before you. We have known each other for a couple of decades, I guess.

Chairman BOLLING. At least.

Mr. PECHMAN. I am pleased that one of the programs that I have supported became law; namely, revenue sharing. I am pleased that you have changed your mind, at least in practical terms, about the program.

As you may remember, I was chairman of the task force that President Johnson set up to study intergovernmental fiscal relations in 1964. We recommended a very simple revenue sharing plan, which the President discarded, it is said primarily because the task force report leaked to the New York Times prematurely. I would not put it beyond them. But I think that there were many more important reasons than that.

Chairman BOLLING. It sounds valid.

Mr. PECHMAN. Then the advent of revenue sharing was delayed for about 7 years. It was a relatively simple concept. It did require public discussion, and in the end, the original plan was modified somewhat, although I was very pleased that the basic elements of the plan were later adopted, in 1971.

The original plan was really very simple. It had the per capita element in it, and then a revenue effort factor. We recognized in the task force report what most of these gentlemen have said, that per capita income is not the best measure of need. But at the time anyway, we threw up our hands about the possibility of getting distributions of income for the State and local governments. Since then some progress has been made, though I do not think the data are that good yet.

In effect, we took per capita income as a proxy for need. Of course, population is also an indicator of need. With respect to the distribution between States and local governments, originally we thought that it would be difficult for Congress to achieve its objectives by a single formula that would allocate money to all the local governments in the United States, so we finessed the problem completely, and suggested that the State governments be given the responsibility of allocating the funds among local governments. This is the only part of the plan that was rejected by the Congress, as you know. Congress saw fit to introduce a specific formula for the local governments. Later on, I realized that for practical, political reasons, it would have been difficult to get through Congress a wide open provision of the sort we had recommended; namely, to let the State governments and legislatures do it, though we had certain constraints on them. We would have required that a majority of local governments and the State legislature approve whatever the Governor recommended for the allocation among local governments.

Instead, the Congress in its wisdom, allocated one-third to the States and two-thirds to local governments. As a result, we now have some peculiarities in the distribution formula that I think Congress will want to remedy in reconsidering the proposal.

On the basis of what I have heard this morning, there seem to be running through two or three threads, Mr. Chairman, that I think are worth emphasizing, because there is agreement among the authors of the papers on a number of things.

First, at least two of the authors suggested that the percentage of people below the poverty line be used, either as a supplement or as a substitute for per capita income. One question I have—Mr. Rohde, you seem to have looked into this—are there distributions of income for local governments available right now?

Mr. ROHDE. Yes; from the 1970 census, the same as for per capita income.

Mr. PECHMAN. We would have to rely just on the 1970 census.

Mr. ROHDE. There may be some way of estimating updates for that, in terms of 38,000 jurisdictions.

Mr. PECHMAN. That is what I thought. The problem we had was that the calculation of the percentage of people below the poverty line would have to be made on the basis of relatively infrequent censuses.

Incidentally, one of the things it seems to me the subcommittee ought to seriously consider recommending is a more frequent census of income, so that we would not have to wait for 10 years, or for small surveys to make these necessary——

Chairman BOLLING. How frequent?

Mr. PECHMAN. I would say once every 5 years, as a minimum. That kind of recomendation certainly belongs in the bailiwick of the Joint Economic Committee. Such data would be useful not only for revenue sharing but also for other important Government programs, not the least of which is the welfare program, the health program, and so on.

That is one thing—I am sympathetic to the use of distribution figures, figures that indicate what proportion of the community's population is poor, as an element in the need formula, simply because the average per capita income itself does not show enough about the characteristics of the population. There may be two communities. each with the same average income, but one with a much heavier concentration below the poverty line, and clearly, we want to assist the latter more.

Another element of agreement among these gentlemen is that they all agree that the limits the Congress imposed on the formula turned out to be counterproductive. Certainly the 145-percent limit, in some cases, denies a local government that is really in need. that really has a low per capita income, funds that it should be getting. I am also sympathetic to either raising or eliminating that top limit.

A third thing that comes out of these discussions is that we still have a problem of how to take care of the large cities in this country. My own view is—I am sympathetic to what these people try to do by formula—my own view is that one general formula for the United States will not take care of that problem. Detroit, Philadelphia, New York, Baltimore—you can name 20 largest cities in the country—I think these cities require special attention. I think it was Mr. Rohde who recommended that, like the States, perhaps a special fund be set aside, for the large cities. This kind of a modification would be justified on economic grounds, as follows: Where you have a community, a city like New York, or Chicago, or Los Angeles, which is more than just a local center—these cities provide services in terms of fire. police, and protection, water, health, and sanitation facilities—so that. the offices of the major corporations in the country will be able to conduct their businesses. The fallout from the existence of a large city both, in terms of improved trade and commerce and in terms of improved access to cultural needs of the community, is very large. And even though you may not live in New York City or Chicago, you. as a citizen of the United States and certainly as a resident of a region, benefit from them, and therefore, some recognition of this in the Federal budget is theoretically appropriate.

The amount that would go for this purpose per capita would be relatively small, but for the cities themselves, even if each of us all over the country contributes a relatively small amount, it might amount to a significant assistance to the major cities. If you set aside such an amount, then we could talk about how to allocate it between the largest cities.

This seems to be one of the major things we ought to confront, this special need of the larger cities.

Chairman BOLLING. Has any study been made of that particular point? It seems to me an entirely valid point; I have not seen anything on it.

Mr. PECHMAN. I have made this point in a number of articles and speeches. I think it is recognized——

Chairman BOLLING. But not quantified.

Mr. PECHMAN. But I do not think it has been quantified. There have been some studies of economies of scale, but not the cost imposed on the central cities and the benefits derived from them by people who live outside.

Chairman BOLLING. At that point I would like to interrupt you if I could.

Mr. PECHMAN. May I just mention one more point about the revenue sharing that has not been mentioned by these people. I hope the Joint Economic Committee will remember that revenue sharing was never intended to take care of the cyclical problem. It was intended to take care of the long-range problem, the relationship between the Federal Government and the States and local governments, but we all knew that when we have a recession, particularly a deep one, that the States and local governments suffer a great deal, both because their revenues tend to be eroded and also because their needs rise as a result of increased welfare requirements and other necessary services. It seems to me that the time has come for the long-range revenue sharing plan to be supplemented by cyclical revenue sharing. This could be easily drafted. It has been talked about, but I am amazed that such a proposal, which I would have thought would get a very good response from Congress, has simply been neglected in this recession year. I would urge that that be given some consideration.

Chairman BOLLING. I heard Charlie Schultz propose that earlier, I guess the first hearings that the JEC had this year. I think perhaps one of the reasons it has been relatively neglected is it has been so overwhelmed by a variety of problems, all related to the same things. We did not really figure out how to relate it to the other problems and their solutions, since some of the solutions that we had at hand were both easier and more popular. Maybe that is why the priority on this one got lost. The JEC did recommend it, however, I am reminded of that. Lee Hamilton. Congressman Hamilton. I thought you might like to get in at this point before that quorum call turns into a real one.

Representative HAMILTON. Thank you, Mr. Chairman. I had detected, along with Mr. Pechman, the common theme in your statements about urban assistance. I come from a part of the country where my biggest metropolitan center is about 40,000. I notice a kind of urban bias in these statements, and Mr. Pechman's comments about the use of revenue sharing as an urban assistance program, in effect, bother me.

First of all, I want to be clear on that point. Are you suggesting that in the General Revenue Sharing program we ought to set aside a certain portion of it to help the big cities, or do you view that as a separate program altogether?

Mr. PECHMAN. I do not care how you do it, but the effect would be the same. Suppose you enacted a revenue sharing program, say, of $10 billion next year. Obviously the needs have increased since the original revenue sharing was enacted to allocate $6 million. If you add $1 billion to the cities, that would be fine with me, or if you allocated

$1 billion to $10 billion to the cities that would accomplish the same objective.

I do think that a special portion of the funds that are allocated for these general grants, general purpose grants, ought to go to the city.

Representative HAMILTON. Is it the general feeling of the gentleman on this panel that the program has an anti-urban bias to the formula?

Mr. SCHMID. I wonder if I could say something about that. We did spend a lot of time working on an evaluation index, where we placed every jurisdiction in the United States into a common program, trying to obtain common measurements. We looked at six categories of needs which are traditionally provided by local governments, and we found that there was a misallocation under the present formula, primarily between the well-to-do suburban communities and the big cities. We recommend a change in that. We find that what happens in the smaller communities, the nonurban centers, is that those that tend to be very stable in population growth, older commuities tend to get allocated fairly under the current formula.

There is some misallocation on the level of the jurisdiction that gets the money, but the present formula does tend to give money adequately to those more stable governments.

Representative HAMILTON. Most of you are suggesting that we take away from the small communities and put it into the larger cities, basically; are you not?

Mr. SCHMID. No; the reallocation, as we see it, is from the wealthy suburban communities.

Representative HAMILTON. Do you cut down the number of jurisdictions that receive money?

Mr. SCHMID. No; those that are affected by the limits are cut.

Mr. ROHDE. I would not say you could categorize the current revenue sharing formulas as antiurban in general. I think it does not make sufficient distinctions for the needs of the very large cities. It probably keeps more than it needs to be given to some of the wealthy suburbs. The thrust of our recommendation, which is that need be measured by percent poverty, with some kind of an adjustment in that for cities because poverty does not fully state the needs of the cities. The effect of this change would be to help the large cities, but it would also help a lot of rural areas that have a great deal of poverty.

So, I do not think you could say the thrust of our recommended formula is more prourban or less prourban than the current formula. We just make distinctions within those groups. With respect to the rural areas, the ones with the greater poverty would be benefited.

As far as the urban areas, the large central cities which have very special needs would be benefited over the suburbs.

Representative HAMILTON. Does the panel generally agree with the statement that the formula needs to be changed so that it is directed more toward dealing with the problems of poverty in both the urban and rural communities? Is that a consensus among you?

Mr. WILSON. We looked at needs as defined by the inverse of per capita income, but we also looked at the magnitude of the functions and responsibilities if a government because in larger cities it turns out that it costs them more per capita to deliver most services than elsewhere. So, in our formula, if the magnitude of responsibilities of a government was great as measured by revenues and if the 145 limit was moved up to 300 percent, that would favor central cities. For example, St. Louis and New Orleans each would gain approximately 35 percent more over their current allocation.

A fact of life about the current formula is that if one jurisdiction within a State gains, others have to lose. It is extremely difficult to come up with a general statement that applies to the 39,000 units of local government across America. There are always exceptions to whatever statement you can make. We looked for general trends. If a central city gains, that money comes from other jurisdictions, and most of the contribution comes from the wealthier suburbs who have, relatively speaking, higher per capita income than, for example, a central city.

Representative HAMILTON. Of course, I do not want to change the formula in any way to help the wealthier suburbs. My observation is that grinding poverty is just as present in the rural areas of this country as it is in the central cities. I do not want to see the formula changed in any way that is going to deny the rural poverty assistance that I think is needed just as much as the center city poverty areas.

Representative LONG. If the gentleman will yield?

Chairman BOLLING. Mr. Long is from an area that has its share of poverty.

Representative LONG. A similar situation exists in another context, I think, with respect to the rural areas. I accept the premise, as I think Mr. Hamilton does, which, it seems to be a general agreement, with respect to the center cities and the fact that they do make a contribution that ought to be given some consideration.

Going from the responsibility in providing services by local government bodies, whether it be in a Louisiana Parish or a small town or the State, moving from that to the providing of services by the Federal Government, existing services by the Federal Government to rural areas where there is a high incidence of rural poverty and illiteracy, most of the studies show that the percentage of people able to participate in those services under existing programs in those areas is considerably smaller than it is in even the center cities.

I know that it is true in my own particular district. I come from a district similar to that one of Mr. Hamilton, where the largest town in my district has less than 50,000. Most of them are small towns, but in none of the Federal programs that we have been able to measure degree of participation, even including, I guess, social security and the medical services which get the highest degree of participation by citizens in my district, have we come up to either the national average and certainly not that in the central cities.

I wonder, in arriving at your formula, if the ability of the Federal Government to provide services, and particularly the one that is just offered us as the Farmers Home Administration and HUD, were the services that they provide, there is practically none in my district. They really close their mind to performing their functions in those areas. Even though we pass the programs, they just, somehow, cannot reach them. I recognize there are problems in it, but what degree has this factor been taken into consideration in the studies you have made in determining the distribution of funds?

Mr. WILSON. We took the current formula as given and adopted the principle, I guess you would say, that revenue sharing, in itself, a general revenue sharing could not accomplish a lot of special purposes, and that it was very difficult to build incentives into the revenue sharing program, simply because, for most jurisdictions, it is a very small percentage of their annual budget; it is 3 to 10 percent roughly. We did take the position that although one could not build in incentives that would have the impact, one could at least remove the barriers that might prevent good management techniques in the collection of taxes or the delivery of services. That was the basic principle underlying our recommendation to expand the definition of the adjusted taxes data element to include user service charges because many governments——

Representative LONG. That does not address itself really to the point I am making, at least, I do not think it does if I understand you correctly. I am speaking of the Federal programs that are now in existence, which the people in these rural areas are not receiving their fair share, those, the inability of the Federal programs, as distinguished from the local programs, as distinguished from the State programs; that they are just not participating in them anywhere near the percentage that those in the inner cities, suburbs are.

Mr. WILSON. Perhaps the trend suggested by general revenue sharing is useful. To my knowledge, this is the first national program that distributes funds to so many local governments, including the smaller rural governments. Perhaps some of the other assistance programs could benefit by some of the concepts embodied in general revenue sharing.

Representative LONG. It seems to me, though, if a case could be made it ought to be the cities ought to receive a special consideration for the contribution that they are making to those that live in the suburbs and that, in turn, a special consideration ought to be made for those who live in rural areas who, because of the failure of the rural area of the Federal programs to service those particular individuals in those rural areas, it just cannot because of the remoteness, because of transportation, because of communication. They cannot service them to the degree they do in the cities.

Now, a valid case could be made for a special consideration there as is made for the cities.

Mr. SCHMID. I wonder if I could just speak to that. We found on our evaluation indicator index that New York City rated very high. One of the two major reasons we found——

Mr. PECHMAN. Rated very high in what respect?

Mr. SCHMID. In terms of need. One of the two reasons for that was the fact that they provide something like one-third of the public transport in the United States as a whole. They do this with the subsidized rate fare.

Representative LONG. In mine, for example, there is none. There is one little bus system.

Mr. SCHMID. Because the tax effort is such an important element of the formula, they arerewarded for providing a higher level or service. The people of New York City do get both the benefit of the services and addditional funds for doing it.

Our recommendation, in contrast to Mr. Pechman's, is the fact that a separate pool should be made for the rural communities, a very low per capita income at some breakoff point. We think it is around $1,600.

Any small rural community beneath that level does not have the capacity to make a tax effort. There is some level of poverty where the discretionary income is so low that they cannot afford to make what is a traditional effort to provide local services. We feel that if there is a separate pool that should be arranged, it is not for the big cities that provide subsidized transport and free universities, but possibly for these extremely poor rural communities that just are not at the level of discretionary income where they can make an effort, and that is our plea for a special pool.

Representative LONG. That is a very valued point, but it does not go to the basic point I am attempting to make.

Mr. PECHMAN. In truth, we ought to agree that to take into account your particular problem would be almost impossible. We really do not know.

Chairman BOLLING. You look at the problem of the cities. I have a peculiar background. I was born in Manhattan and grew up in north Alabama in the 1930's, and I represent a relatively medium-sized city. What has happened in the last 30 years is a very curious reflection of the failure to deal with the problem that Mr. Long is talking about in the 1930's. The central cities have been inundated, and I think this is statistically sound, as well as apparently so, by people who came there for jobs and for opportunities, and by people who did not come there for the cultural benefits. They came there for the lesser benefits of Government services that were absolutely essential, and that has tended to exacerbate the whole problem of the society in its overall living situation.

We have developed these poor cities, which had all the social difficulties, all the economic difficulties. We are now seeing for the first time the return from the cities to land. I guess that is too spotty a statistical illustration of change, but it would seem that people are revolting from the cities. All the dilemmas that New York has are not being exported, but are beginning to turn up in smaller cities, I believe, certainly the economic dilemmas, and the society has done exactly the reverse of an effective job of dealing with the problem of rural poverty being transferred into city poverty, accumulating, aggravating, becoming disaster, both in terms of economics and social matters.

It seems to me that one of the things we have to address ourselves to, even in as unique a program as this, is the problem of how you prevent a continuation of a trend that has not really been a great success. I know that is a terrible generality, but it also is a very specific thing.

My town, Kansas City, for the first time is becoming a favorable enough climate so that people are beginning to stop there instead of go on. They used to go on to Chicago and to Detroit as they migrated out of the less prosperous rural areas in Missouri and then beyond the borders of Missouri.

I do not know the answer, but it seems to me it is a question that has to be taken into account, even when one discusses so narrow a program, relatively speaking, as revenue sharing. Does it not have a pertinence?

Mr. PECHMAN. Indeed. Could I address myself to the question of the rural group. Revenue sharing was not intended to replace categorical grants. It was intended to supplement categorical grants.

Among the programs the Federal Government runs—or used to run, maybe they have changed the name—we had a rural development program. They also have health programs, welfare programs, and so on. It seems to me that the direct categorical grants should be beefed up to take care of the rural group.

You are talking about a rural group of relatively sparse population. What kind of general government are you going to support other than minimum general government anyway? What you want to do is direct the Federal funds to the people in that community who are poor. I do not think your suggestion of a sepcial fund is inconsistent with the general rationale of revenue sharing. However, if there is a problem, I would take care of it by categorical grants rather than by a special fund in general revenue sharing.

Mr. ROHDE. I would like to address myself to the point Mr. Schmid made, also.

I think the problem of rural communities that are extremely poor, say a per capita income of $1,500, not being able to have a meaningful tax effort under the normal definition, at least in the statute, is a real problem. Another way of addressing that, instead of setting aside a special pool, is to change the definition of tax effort. Instead of counting all income as the capacity, just count income above the poverty level. On a per capita basis, if a community had a per capita income of $1,500, that would be considered per capita income of $500 that was tax capacity. If you do that across the board with other jurisdictions, that would allow those rural very poor jurisdictions to have a tax effort, I think, that could compete with and would be comparable to other communities of the United States.

Mr. SCHMID. We tried to do that. It is very difficult with the current elements to come up with a national allocation formula under that.

Mr. ROHDE. We have done a number of simulations with an alternative tax effort which is simply using the same adjusted taxes in the numerator and changing the denominator. Instead of using, in effect, per capita income, using per capita income minus $1,000 because as of the 1970 census from which the per capita income data was taken, the poverty level, in effect, was about $1,000 per capita. We found that tax effort, using it that way, worked much better than the current definition of tax effort.

Mr. SCHLOSSTEIN. That still does not deal with the distributional problem, you are still using average per capita incomes and separating out an average of $1,000.

Mr. ROHDE. What I am saying is that, I think, the one place where per capita income does have some relevance is in the measurement of fiscal capacity, as distinct from the needs for services, so use percent below poverty to measure need for services and for the fiscal capacity, which is used as a measure in the denominator of the definition of tax effort, use income above the poverty level.

I think the joint effect of using those two works very well.

Mr. PECHMAN. One other point about categorical programs. One thing, it seems to me, that needs to be done separately from general revenue sharing is for the Federal and State Governments to assume responsibility for financing the welfare system. This has been done in most States, but in some States that is not the case, the local governments still share in the cost of welfare. New York City is an important example of that.

It is about time, it seems to me, that the Federal Government mandate either that it take over the financing of the welfare system or do it jointly with the States. Local governments clearly are not capable of taking care of the welfare system. I believe if you took care of that problem, it would help a great deal over and above what you could do with revenue sharing.

Mr. SCHLOSSTEIN. One thing that both Mr. Pechman and Mr. Schmid's remarks have in common about the urban, rural areas is that both of those areas are in a sense bearing an extra burden because they happen to have within their jurisdictions a larger percentage of the poverty or the dependent population in our society. Clearly, if you are going to have a general government assistance program, it should be one of the major functions of it, to reward those communities that are bearing an excessive burden of the poverty population.

You cite the welfare costs, Mr. Pechman, as being one of the major manifestations of the burden placed on a jurisdiction by this poverty population. Are there other services that are provided by local government? If you were to finance welfare at the State or the Federal level, would there still be this need to take into account the excess burden imposed upon these jurisdictions by low per capita income people?

Mr. PECHMAN. I think you could probably say that health and housing are two other areas where programs should be more general, should be directed to people rather than to governments; yes.

Chairman BOLLING. Maybe it is appropriate to raise the question of what would be. Has not the fact that New York City, for example, had a great many public services of various kinds and a rather generous welfare program, had a direct impact on the population distribution by income and so on and so forth in New York City?

Mr. PECHMAN. You mean it is attractive to poor people who might otherwise not?

Chairman BOLLING. Yes; is that true—if it is true?

Mr. PECHMAN. There must be an element.

Chairman BOLLING. If there is an element of truth in that, then is it not then terribly important at what level, whether it be Federal or State, that such programs are taken over.

Mr. PECHMAN. My own view is that is a Federal problem, that poverty is a Federal problem. People who are now poor and living in New York City or Baltimore are not necessarily those who are raised in those particular States. They come from other areas, their poverty is the result of many factors, lack of education, family backgrounds, poverty in previous generations, and discrimination. All of these elements combine to make this particular group of people poor at this particular time, but it is not the fault of Maryland or New York City or New York State.

Chairman BOLLING. Is it not the problem that the country has to face if, for humanitarian reasons or generosity or whatever reason, a particular jurisdiction is a better place to live if you are poor and without much employability? Is it not then the inevitable result of that if it is not standardized, if it is not evened out, is it not inevitable that the area that does the best job in humanitarian terms is going to get the worst punishment in terms of the viability of its financial and economic and so on situation?

Mr. PECHMAN. I think there is no doubt about it.

Chairman BOLLING. Does that not mean whether you like it or not you are stuck with going to the Federal Government?

Mr. PECHMAN. That is my view.

Chairman BOLLING. Does that mean you are stuck with going to the Federal Government on all of the elements that make for a level of income for the relatively unfortunate?

Mr. PECHMAN. As you know, I am in favor of a national negative income tax.

Chairman BOLLING. I know you are, before you get to that, for example, I am the successor chairman to a lady who did a monumental study on welfare. There are 20 papers, 20 enormous efforts, I know they are not going to be allowed to disappear only into academia, I know there will be some kind of an effort to translate that into a form of action. It seems to me that the significance of that in relation to the thing we are discussing is terribly important.

Mr. PECHMAN. I agree with you that a national welfare system or a national negative income tax is still some way off. It seems to me that financing the present welfare system at a much higher relative level by the Federal Government is within the realm of possibility for Congress to do. The quicker the Federal Government takes the full financial load, the better.

Chairman BOLLING. That is what I was going to try to reverse. Suppose we did do something like that, what then would be the effect on what we have been talking about on revenue sharing as such and on the formula for revenue sharing? That is the reason I want to pursue it in this context. It would seem to me it might have a rather dramatic impact; maybe I am wrong, maybe I am misreading what I am hearing. Would not a great many things change if you had a nationalization of welfare?

Mr. PECHMAN. Absolutely, a lot of the need elements that arise in these people's formulas in the large cities would drop out. And the revenue effort needed for that purpose would also drop out.

Mr. SCHMID. Essentially, one-sixth of our evaluation was on social welfare payments—health, recreation, transportation. sanitation services—these other traditional services provided by local governments would still remain as they are.

Mr. ROHDE. Poverty is still a big problem contributing to a lot of the need for those services.

Mr. PECHMAN. I think you have to add, Mr. Chairman, the financing part does not take care of the fact that poor people do not have a capacity to pay taxes. We are talking about trying to help units of Government to provide services. We know that in most areas of the country, poor people are burdened by the tax system, but in fact, these taxes should be reduced or eliminated so by taking over the welfare system we will help the communities that are now burdened by it. It still does not mean you should not take into account poverty in deciding on how to allocate the general revenue sharing funds.

Chairman BOLLING. But, of course, Mrs. Griffith's study, I obviously have not had an opportunity to read each of the papers myself, revealed that in income maintenance generally it was not equally outrageous, it was significantly outrageous at both ends of the spectrum. There were in fact, what the conservatives are always howling about, people who have become highly skillful are getting more than their fair share of a welfare or income maintenance.

On the other hand, there were a great many more people, the ones that the liberals are always talking about, who were getting no share at all, were left out completely. I think Mrs. Griffith's studies and work demonstrated factual support for both arguments which I think would probably constitute the worst possible indictment for the effectiveness of the system.

What I am trying to get in my head is sort of the relationship between this kind of program and that kind of program because while we are concerning ourselves primarily now with the improvement of this program, the effect on this program of a variety of other things that we might all be for or might all be against is pertinent to a discussion of improving the formula of this program. That is why I am persisting in this.

Mr. ROHDE. I do not think it is necessarily an either/or proposition. There is certainly a great need for some kind of national income maintenance program.

But, even if you had that and you still wanted to have a revenue sharing plan, I think that poverty is still an important element in that. As an interesting sidelight, Mr. Pechman had some questions about the data base, getting good figures on percent poverty. If we had a national income maintenance plan that would greatly simplify the ability to update data on proverty. So we would get a better system that way, too.

Chairman BOLLING. That leads me to the next thing I am curious about. I was for a long time, at least in the beginning, part of an attempt by Congress to participate in the improvement of Federal statistics. I was for a long time the chairman of the Joint Economic Committee, Subcommittee on Economic Statistics. Since one point came out that we needed a census of income every 5 years rather than at the present every 10, I would be interested to hear from all of you if there are other series that perhaps more than others very badly need improvement either in frequency or in quality or reliability, in a variety of different ways. It seems to me that our ability to deal effectively with a great many of these programs in the future is going to depend absolutely on the quality of information.

Mr. WILSON. Our team did the general revenue sharing data study for the Office of Revenue Sharing, it was published last August. We looked quite critically at all the data elements in the current formula and searched for alternatives. We did recommend a mid-decade census. Of course, that really will not have an impact until 1985. We did discover that per capita income was the weakest of the data elements employed in the current formula. I understand that the Bureau of Census will enlarge their 20-percent sample to some higher number in 1980 to increase the reliability of that statistic.

The Bureau of Census has issued new population and per capita income figures for all 39,000 units of local government as a result of the intercensus estimating technique that was recommended in the original legislation. So that has at least improved the timeliness of per capita and population data. It has moved it forward by about 3 years at some expense in accuracy.

We also recommended that research continue in the area of developing a better indicator of need. However, in our current study, we could not find a better indicator than per capita income. We rejected three or four other alternatives that we looked at. That does not necessarily mean that PCI is the best, we just could not find a better one that could be operationalized in the next 2 or 3 years.

The current general revenue sharing survey that is administered by Census for the Office of Revenue Sharing is an annual survey that perhaps collects the most timely data on all of these 39,000 units of government spread across America. And that, of course, is used for adjusted taxes and intergovernmental transfers.

Mr. PECHMAN. That is a sample, the annual estimates are based on a sample?

Mr. WILSON. No, sir.

Mr. PECHMAN. You mean they take a census of——

Mr. WILSON. They send out these forms to all local governments except in some instances the States have agreed to fill in the forms for the local governments within the States. The Office of Management and Budget and Census are trying to extend that program and I believe now about 21 States have agreed to do it for their local governments. So that is a source of quite timely data that cuts across all 39,000 units of government.

We hitched our adjusted revenues recommendations onto that form because the incremental cost of doing that would be almost negligible.

Mr. PECHMAN. One other thing you raised in connection with statistics. I would be interested in getting more data about a broader revenue concept than taxes. I agree with the general position that you take, we ought to do more than just use taxes. But I would be hesitant to include all receipts of all local governments. That would include tuition fees, fees for health services and so on. I think that, if we are going to move toward a broader revenue base than taxes, we ought to know more about the nontax receipts of local governments because right now they are not recorded very well. Is that not right?

Mr. WILSON. Yes, sir.

Some of the data you can obtain at the county level, there are about 3,045 of those in America. But to push it down to the 39,000 units of government, especially those 27,000 that have a population of 2,500 or less, becomes quite difficult.

Representative LONG. May I pursue the point, Mr. Chairman? I apologize for being late and having to leave, I will pursue the point that I was pursuing before, I got a statement that I made on the Senate Subcommittee on Housing and Urban Affairs the other day. I do not recall the figures exactly. We were speaking here particularly of the problems of transportation in rural areas. We do not know from the existing data, or we do know from existing data that while additional proportionately higher percentage of elderly- and low-income people live in rural areas, there is no substantial rural transportation systems there.

The American Public Transit Association indicates that of the 20,000 towns with populations of 50,000 or less, only 313 out of that had such systems in 1975 which in itself was a net decline from 2 percent to 1.5 percent in just 3 years. This is not an encouraging trend. Unfortunately the history of implementing existing legislation by the Department of Transportation does not generate any optimism.

Back in 1972, a Senate Agricultural Committee report told us that most rural noncommuter counties have double the incidence of poverty than in nonrural counties although they get a mere token return from most Federal Delivery Service programs. In 1972 these counties received only 2.1 percent of Federal outlays for basic adult education, 5.5 percent of health services, and 17 percent of Federal elementary and secondary education appropriations. The same report concludes that the dearth of transportation resources in rural areas is a central factor in the failure to properly deliver these services.

It is 1975, I still do not think we have begun to address the central problem yet. For example, the annual report required by the Rural Development Act details the amount of Federal funds that reach rural areas and the latest report tells a very disturbing story. The nonmetropolitan breakdown was subdivided into three categories, that is the rurals were really divided into three categories. To give a more accurate picture of where the funds were going they called them urbanized, less urbanized, and thinly populated. Total mass transit funds allocated to nonmetropolitan areas appears to be 4.3 percent but of these three categories in the nonmetropolitan area of breakdown, the thinly populated areas got zero funds. The less urbanized areas got zero funds and the entire 4.3 pecent went to the urbanized nonmetropolitan areas. So even within the category once you do get into the rural areas, there is a breakdown in their ability to provide services. I am not speaking of those, or through those, but through the direct Federal programs. Even there it appears to be if we are going to do some recapitulation with respect to what the formula ought to be. This seems to be a factor that should be taken into consideration.

Mr. PECHMAN. Mr. Long, I mentioned just after you left, I would like to repeat it, the point in that connection you cannot do everything with a general revenue-sharing formula. I am very sympathetic to the point you make. It seems to me that that kind of inadequacy has to be taken care of by direct categorical grant programs.

We have a rural development program, we have a health program for the poor, there are housing programs and so on. It is that kind of an activity that Congress ought to beef up for the rural communities so that people who are there live in decency.

Representative LONG. I agree with you. That, of course, is what I was trying to do when I went over and testified. I was trying to get them to move more in that field.

Mr. PECHMAN. I would like to distinguish between poor people and poor governments. There are some places that are poor like New York City where average per capita income is very high. With respect to poor people, Federal activity—all Government activity—ought to be directed at the people themselves. We ought to provide them with health care, with housing, and if they need cash assistance we ought to give them the cash assistance directly.

Now, aside from that, we then have to ask ourselves whether the local and State governments we have are capable of furnishing the kinds of public services that are needed with the available fiscal resources. That is a separate question. There we have to decide how much they need, and how to allocate the money to the governments directly. I would say that, if we take into account per capita income and the incidence of poverty, you are doing a good job of measuring governmental needs, not people needs.

The people needs are quite separate. I agree with you 100 percent, there is inadequate transportation, we ought to make sure they have transportation. Even if you add another dollar to the revenue-sharing grant, you are not going to get the transportation to them. It is just not enough. There is nobody who is going to supervise it; general revenue sharing is not designed for that purpose.

Mr. SCHMID. I am not sure that is true. Two groups that have been identified stand out for having a lot of dependent people; the urban centers and the poor rural areas. There is one key difference between these two groups. The urban centers have been drawing in migrations of poor people for the last 20 years, while the rural areas are losing them. There are two key reasons for this: one is jobs, but two, the level of services provided by the local governments is much greater in the urban areas.

If the revenue sharing program gives priority to the urban areas, there is the danger of the perverse result of increasing migration which is increasing the problems. It could well be that the best way of dealing with the problem is to recognize that the greatest needs are those rural areas who do not have the money to provide services so that they can provide a comparable level of services, free education through the university levels, subsidized transport systems, pension plans, and extremely high civil service salaries, the whole level which, as you say, New York does provide.

But that is not a need New York has, that is an accomplishment New York has done.

Mr. ROHDE. You have to do both things. The problems of New York City and other large urban centers are not going to disappear if you start to help these rural very poor places, which you have to do, I think the recommendations that we have made would do both of these things.

Mr. SCHMID. I think it is a matter of priorities we are talking about.

Chairman BOLLING. The reason I raised the question of the relationship in the first place is that I remember as a boy in the rural South listening to the early New Dealers explain that if we wanted to prevent these disasters in the forties and fifties in the cities which we have now lived through that we have to somehow keep the people down in the rural South. That was exactly the theory that was being expounded in the early thirties by the New Dealers who were not listened to and whose programs were not implemented.

And the thing I am interested in, having lived quite a while and been in politics quite a while, is to see us come again to another situation where we may fail to recognize that the problem is not reversing itself, it just is getting more acute in both areas because as those rural areas have fewer and fewer people there is less and less likelihood of Government services. And as the economic situation of the cities become more and more acute our attention is likely to be diverted entirely from the continuing source of a great deal of the problems of the cities.

It seems to me this is a pertinent part of the consideration. Perhaps not, maybe even of the formula in revenue sharing certainly it is a question, a legitimate consideration in looking at the whole question of revenue sharing.

Mr. PECHMAN. I think you should add to the list of things the subcommittee might recommend for study is the point that was brought up earlier. I do not really think the economists and political scientists have answered the question for practical policymakers as to what level of services is really required. What do we mean by government in a rural area and government in a 25,000-population city and government in a city of a million?

Until we get some idea as to what the needs and the cost of government are, we will not really be able to answer your question, Mr. Long. I think it is a very good point, but we really do not have the data yet.

Representative LONG. The idea of doing a census every 5 years—how long does it take to gin up for one of these? A couple of years?

Mr. PECHMAN. Yes.

Representative LONG. Possibly, we could do one in 1977 and then another one in 1980, and then one in 1985. Is that feasible?

Mr. PECHMAN. I would doubt you could put one in before the 1980 census. I think that the most practical thing you can do is to direct the Census Bureau to consider a 1985 census.

Chairman BOLLING. Do they not finish one and start the other about the same moment?

Mr. PECHMAN. That is right.

Chairman BOLLING. I think even now—we did go to shorter than decennial. It seems to me we just had a dreadful time making the shift. It is a monumental kind of a task.

Are there further comments or questions? If not, I want to thank you all for your contribution. We are grateful to you for your time and your effort. We hope that between us we will make some contribution to the making of policy, as well as the discussion of policy.

Thank you, very much.

The subcommittee stands recessed until tomorrow.

[Whereupon, at 11:55 a.m., the subcommittee recessed, to reconvene at 10 a.m., Wednesday, June 25, 1975.]

GENERAL REVENUE SHARING PROGRAM

WEDNESDAY, JUNE 25, 1975

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to recess, at 10:05 a.m., in room 1537, Longworth House Office Building, Hon. Richard Bolling (chairman of the subcommittee) presiding.

Present: Representatives Bolling and Long.

Also present: Ralph L. Schlosstein, professional staff member; Michael J. Runde, administrative assistant; and George D. Krumbhaar, Jr., minority counsel.

OPENING STATEMENT OF CHAIRMAN BOLLING

Chairman BOLLING. The subcommittee will come to order.

This morning the subcommittee on fiscal policy holds the second in a series of hearings on the General Revenue Sharing program. Today's hearing will focus, once again, on suggested alterations in the revenue sharing distribution formula.

Yesterday the subcommittee heard testimony from five witnesses concerning the need to modify the existing distribution formula, making it more responsive to the varying needs of the population and to the magnitude of services provided by different governments. While the suggestions received varied considerably there was general agreement about three basic propositions. First, all of the witnesses agreed that average per capita income was a relatively poor measure of need. Most of the witnesses suggested that the formula should incomporate some measure of the percentage of the population in poverty to replace per capita income.

Second, concern was expressed about governments, both urban and rural, that have such high poverty populations that no national formula can meet their relative needs. And finally, there was agreement that the constraints and limits on the formula were distorting, in some cases at least, the true effectiveness of the program.

Today, the subcommittee will continue its consideration of the distribution formula, focusing on some of the structural components of the formula.

We will receive testimony from four of the principal researchers on the National Science Foundation alternate formula projects. They are Mr. G. R. Stephens, University of Missouri; Mr. Barry Jesmer, the Center for Governmental Research at the University of Rochester; Mr. Morton Lustig, University of Pennsylvania, and Mr. Robert

Strauss, formerly of the University of North Carolina and now with the Joint Committee on Internal Revenue Taxation. In addition, we are fortunate to have with us Mr. Richard Musgrave, a professor at Harvard University and a distinguished scholar in the field of public finance. Mr. Musgrave will interpret, discuss, and synthesize the work presented by the other witnesses.

And I would like to say, when in the 1950's I held similar hearings on different subjects, we didn't have sense enough to have Richard Musgrave, or a Joe Pechman, I took on that job myself; I like it much better this way.

I would like to ask all the witnesses to limit their opening remarks to 10 minutes, and I will sort of generally enforce that, so we will have some time to discuss among ourselves—and I do it rather gently and with some flexibility. I try to interrupt at a point where it makes some sense. But I would like you to try to hold it to 10 minutes, if you can, and of course include anything you wish, really, within reason, including all of your longer statement in the record. I ask unanimous consent for that, and without objection, it will be done.

And I would hope when we get to the discussion period, that both the atmosphere and the discussion will lead to an interchange; that we will have a free interchange. I find that if we can get a few members here and interested by the statements, and if you are interested and stimulated, we have an interaction that is much more useful than our just sitting and looking at each other, and listening politely to each other's statements; if we can get interaction going, it will be a help. And, of course that means that we are going to be informal.

So, we will begin with Barry Jesmer, Center for Governmental Research, Rochester University.

STATEMENT OF BARRY JESMER, CENTER FOR GOVERNMENTAL RESEARCH, INC., ROCHESTER, N.Y.

Mr. Jesmer. If I can correct the record, Mr. Chairman, I will start with, the Center for Governmental Research is a private, nonprofit separate corporation, and is not related to the University of Rochester.

Chairman Bolling. Right. We are delighted to be corrected.

Mr. Jesmer. We have been in business since 1915 for the continuing purpose of improving local government.

The overall purpose of the center study was twofold. First of all, to evaluate the impact of the present revenue-sharing allocation formula, and alternative formula modifications in relation to selected formula goals; and second, to describe the pattern of revenue-sharing allocations created by the present and selected modifications across jurisdictions with different social, economic, and political characteristics.

Our principal goal is to select a revenue-sharing formula which does not discourage, or distort local variations of financing and delivery services, and we call that principal goal "neutrality".

In addition to the principal goal we had some secondary goals to help shape that principal goal, and they were fiscal need, reduced limits, responsibility split, data availability, and simplicity.

In the beginning, the way we viewed it, the supporters of the revenue-sharing concept are divided rather strictly into two groups, one proposing intervention, and the other proposing neutrality.

The Local Assistance Act of 1972 obviously failed to satisfy the "interventionists," and also the act appears to violate the objectives of the "neutralists."

In order to further the neutrality of the allocation formula, the study focuses on features of the revenue-sharing formula which have distortive or discouraging effects on local variations in financing or delivering services. One of these is the change in the ratio of State and local expenditures and revenues. We use as an example of that the North Carolina "go slow" policy in State aid as a result of revenue sharing. We also cite the shift from user charges, and other ineligible revenues to taxes; and that is connected with the definition in the present law.

We also cite the changes in corporate status of municipalities to townships, for example, as a result of the current intracounty allocation process. Also, there is a preference for incorporation of limited purpose governments as a result of the minimum limit, and transfer of functions of constrained jurisdictions to unconstrained jurisdictions as a result of the per capita limit.

Four major formula components that we determined had a significant effect on the selected goals were the replacement of the fixed State-local split by an element which adjusts the "split" depending on the proportional fiscal burdens of the two levels of government within each State. We accept, overall, the one-third/two-thirds distribution between State and local government. But we feel that ratio ought to be altered State by State, depending upon the mix that exists within an individual State.

We are also recommending the replacement of the "adjusted tax" element by a more comprehensive measure of revenue.

We also recommend the removal of the 20-percent per capita minimum or floor, but at the same time the retention of the 145-percent ceiling.

Finally, the adjustment of the intracounty allocation process, so that townships are included in the same group as other units of local government, eliminating the present separate treatment of townships in the 21 States with such units.

The results of the research undertaken support the validity of the proposed modifications of the present general revenue sharing allocation formula. Each of the modifications is considered to represent an improvement over the present formula in achieving one or more of the goals mentioned above. The composite formula is a better goal achiever than the present formula, or any of the individual modifications. The proposed formula modifications concern only the intrastate allocation process. Data elements for the proposed modifications are readily available. The estimated net change in the cost to implement any of the modifications is insignificant.

Three of our options have minimum effects, but the State-local split modifications produces substantial changes by itself and as a part of the composite. At the State level there are few changes. In terms of direct allocations received by local governments, however, there are substantial changes in the social, economic, political, and formula variables. With any formula change where there is a constant sum game, there must be winners and losers. As you well know, effects created by change can be softened by gradual implementation, save harmless provisions, and special allocations.

Revenue sharing in this country is very new. Indeed, most local governments have only gone through two budget cycles with the program as a factor. After researching the program, it is our opinion that the allocation formula is well designed. The program allocates funds to about 39,000 governments in a new and important way—allowing them to set and be responsible for their own priorities within broadly stated Federal policies. It is a good start in the right direction. We are suggesting some fine tuning for the next round. Thank you.

[The prepared statement of, and a summary of a report prepared by Mr. Jesmer follow:]

PREPARED STATEMENT OF BARRY JESMER

Introduction

I am here representing the Center for Governmental Reesarch of Rochester, New York—a non-profit, non-partisan research institution founded in 1915 for the continuing purpose of improving local government and the quality of community life. My purpose today is to report to you the results of a research project on alternative allocation formulas for General Revenue Sharing—a project prepared under a grant from the National Science Foundation. I am the principal investigator for that project.

In making this statement, I propose to cover the following points:

Overview of our research on the formula and goals for the design of the formula;

Importance of revenue sharing as an approach to implementing national policies;

Importance of our allocation formula which is neutral in its effects on local government;

Furthering the neutrality goal or policy by modifying the allocation formula;

Research findings on formula modifications.

A more detailed project summary was submitted in adanvce—and, of course, the full project report is also available through the Research Center or the National Science Foundation.

Point 1. Research Overview

Our research efforts represent only a very small part of the overall publicly- and privately-sponsored research on general revenue sharing. Nevertheless, we feel that our efforts are particularly significant—and should prove useful to your debates on possible formula modification.

The overall purpose of this study was two-fold: (1) to evaluate the impact of the present revenue sharing allocation formula and alternative formula modifications in relation to selected formula goals, and (2) to describe the pattern of revenue sharing allocations created by the present and selected modifications across jurisdictions with different social, economic, and political characteristics. The *principal formula goal* selected for this study is the design of a revenue sharing formula which does not discourage or distort local variations in financing and delivering services (neutrality). Five ancillary goals were also selected to be used in the design of formula modifications: (1) Fiscal need. The formula should allocate funds to jurisdictions in accordance with fiscal needs and responsibilities. (2) Reduced limits. The degree to which revenue sharing allocations are determined by arbitrary limits should be reduced. (3) Responsibility split. The formula should ensure splitting funds between state and local governments in a way which reflects variations in state-local fiscal responsibilities and needs. (4) Data availability. The formula should be designed to utilize reliable data elements and to reduce administrative cost. (5) Simplicity. The formula should be less complex.

Point 2. Implementing National Policies

In our federal system, several alternatives exist for implementing national policies: (1) direct implementation by the federal bureaucracy; (2) categorical grants-in-aid to state and local governments overseen by the federal bureaucracy: (3) monetary support tied only to broad federal policies. Obviously, these are points on a continuum rather than absolute alternatives. The federal government has experimented and continues to experiment widely with the first two points (direct implementation and categorical grants) but has only explored the third point, in any major way, through general revenue sharing. The importance of this experiment to both the federal system and the vitality of our local governments cannot be overstated.

General revenue sharing represents the major effort by the federal government to support decentralized local government in the United States. Revenue sharing reinforces local government as an alternative means for implementing broad national policies. A means that is highly representative and flexible—that recognizes special local needs, minimizes bureaucratic red tape, and provides ready accountability for actions taken. Revenue sharing contributes to one of the great strengths of our current local governmental system—its variety: with its stress on public choice and the need to adapt even national policies to local conditions.

I believe that the fact that our local governmental system represents a great national asset needs to be stressed. We frequently stress its not inconsiderable problems and weaknesses. While these must be dealt with—and, in many instances, are being dealt with by feredal, state, and local governments—the basic strengths of local government cannot be ignored. Congress has, of course, generally recognized a major strength of local government in the revenue sharing program—its variety and ability to arrive at unique solutions to the problems of individual communities.

Point 3. Neutrality in General Revenue Sharing

Supporters of the revenue sharing concept were divided rather distinctly into two groups; one proposing the use of revenue sharing as a means of intervention to modernize state and local government, the other advocating that revenue sharing should be neutral—maintaining that the currents and eddies of change already in being, whether inspired by local or state action, should not be directly influenced by the revenue sharing program. Both sides consider their views in harmony with the New Federalism.

The neutrality advocates believe that any restructuring of local government must be arrived at freely and without federal interference in the state and local political market place. A high degree of diversity of governmental structures and processes exists throughout the nation and what is deemed desirable in one area may be considered undesirable in another. Revenue sharing, they hold, should provide additional financial means to all types of state and local governments to permit them to escape from the paralyzing grip of the federal bureaucracy and to determine their priorities as they, not the federal agencies, perceive them. This view was shared by the sponsors of the Nixon proposals and those of similar bills.

The Local Assistance Act of 1972 failed completely to measure up to the standards demanded by the "interventionists." At the same time, the act also appears to violate the objectives of the "neutralists." The very infusion of moneys into all general purpose jurisdictions, no matter how small and no matter how limited the scope of services rendered, has strengthened their ability to resist pressures for structural and organizational reform. Moreover, a number of the formula elements act as encouragements for some structural and procedural changes, insofar as such changes tend to maximize a municipality's revenue sharing allocation. Finally, the inability of the formula to provide funds more nearly in accordance with fiscal needs, because of the exclusive use of taxes to measure relative effort rather than general revenues, and through the imposition of allocation minima and maxima, discriminates among different jurisdictions—a discrimination considered as a type of negative interference by those governments which feel they are being deprived of their fair share because of the formula's unequal recognition of legitimate variations in structure or effort.

Point 4. Furthering Neutrality by Modifying the Allocation Formula

In order to further the neutrality of the allocation formula, the study focuses on features of the revenue sharing formula which have distortive (or discouraging) effects on local variations in financing or delivering services. Differential recognition by the formula of otherwise legitimate service and fiscal variations tend to force a locality to change (or resist change) in order to maximize its revenue sharing allocation. Implicit in the formulation of the study's goal of increasing the "neutrality" of the formula is the objective of equal treatment of equals. To the extent that features of the allocation formula favor one jurisdiction over another or provide benefits not in proportion to existing differences among jurisdictions as calculated by the three factor formula, they offer incentives to jurisdictions to acquire the characteristics of more favorably treated jurisdictions or undertake data manipulations to raise their allocations to the highest possible level.

Specific non-neutral or distortive features of the formula address in this study are:

A. Those which encourage the maximization of revenue sharing receipts in absolute or relative terms through the change of variables under a jurisdiction's control. They are distortive in that the change of such variables would not have occurred without revenue sharing. Examples of such distortions (responsible formula features in parenthesis) are:

1. Changes in the ratios of state vs. local expenditures or revenues, e.g., North Carolina's go slow policy on state aid (state-local split);
2. Shift from user charges and other ineligible revenues to taxes (definition of general tax effort);
3. Changes in corporate status, e.g., municipality to township (intra-county allocation);
4. Preference for incorporation of limited purpose governments (minimum limit);
5. Transfers of functions from constrained jurisdictions to unconstrained jurisdictions (per capita limits).

B. Those which affect existing jurisdictions through patently discriminatory treatment, e.g.:

1. Artificial decrease of calculated revenue sharing for high tax and low income governments (maximum limit);
2. Artificial increase of calculated revenue sharing for low tax and high income governments (minimum limit);
3. Non-recognition of non-tax revenue effort by local governments which by state statute cannot increase eligible taxes or which by choice use other means of public financing (definition of general tax effort).

Four major formula components were determined to have a significant effect on the selected goals. The following modifications of these formula components were tested on a national basis:

1. The replacement of the fixed state-local split by an element which adjusts the "split" depending on the proportional fiscal burdens of the two levels of government within each state (providing more weight to locally raised revenues);
2. The replacement of the "adjusted tax" element by a more comprehensive measure of revenue;
3. The removal of the 20% per capita minimum or floor (but retention of the 145% ceiling);
4. The adjustment of the intra-county allocation process so that townships are included in the same group as other units of local government (eliminating the present separate treatment of townships in the 21 states with such units).

A "composite modification" contains each of these individual formula element modifications.

Point 5. Research Findings

Our work involved evaluating selected modifications in terms of goal achievement and national distributional effects. All of the proposed modifications satisfy certain selected goals: neutrality, data availability, and simplicity. The state-local split modification was shown to reflect variations in state-local fiscal responsibilities and needs. The expansion of the fiscal effort measure more adequately recognizes the relative fiscal effort of recipient local jurisdictions. The per capita modification (removal of the 20% minimum) provides previously constrained units with an amount of revenue sharing which is more commensurate with their fiscal needs and, of course, substantially reduces the overall number of units affected by limits. The intra-county formula modification equally recognizes fiscal need for all types of local governments. In combination, these modifications most highly attain the principal and ancillary goals of this research.

Nationally, each of the modifications produces changes in distributional patterns from the present which vary considerably in magnitude. The state-local split modification produces the most significant changes among all individual modifications—primarily between state and local governments within state areas, and in low income, non-white, and Spanish American areas. Changes produced by the fiscal effort modification are less significant: there is an overall shift to municipalities, and a small increase in the number of units affected by formula limits. Under the per capita modification there is a shift of revenue sharing from townships to counties and municipalities and most major cities gain. The intra-county formula modification produces virtually no changes on a national basis from present patterns. The composite modification results in the most significant changes from the present formula patterns. As expected, many of the effects produced by the individual modifications appear again in the composite national test.

Conclusion

The results of the research undertaken support the validity of the proposed modifications of the present general revenue sharing allocation formula. Each of the modifications is considered to represent an improvement over the present formula in achieving one or more of the goals mentioned above. The composite formula is a better goal achiever than the present formula or any of the individual modifications. The proposed formula modifications concern only the intra-state allocation process. Data elements for the proposed modifications are readily available. The estimated net change in the cost to implement any of the modifications is insignificant.

Three of our options have minimum effects, but the state-local split modification produces substantial changes by itself and as a part of the composite. At the state level (local allocations plus a prorated share of the overlying state government allocations) there are few changes. In terms of direct allocations received by local governments, however, there are substantial changes in the social, economic, political, and formula variables. With any formula change where it is a constant sum game, there must be winners and losers. As you well know, effects created by change can be softened by gradual implementation, save harmless provisions, and special allocations. Revenue sharing in this country is very new—indeed most local governments have only gone through two budget cycles with the program as a factor. After researching the program, it is our opinion that the allocation formula is well designed. The program allocates funds to about 39,000 governments in a new and important way—allowing them to set and be responsible for their own priorities within broadly stated federal policies. It is a good start in the right direction. We are suggesting some fine tuning for the next round.

PROJECT SUMMARY [1]

General Revenue Sharing: Designing a Formula Which Does Not Discourage or Distort Local Variations in Financing and Delivering Services

(By Barry Jesmer, Principal Investigator, Friedrich J. Grasberger, Jeffrey O. Smith, and Alan J. Taddiken)

RESEARCH OVERVIEW

[The overall purpose of this study is two-fold: (1) to evaluate the impact of the present revenue sharing allocation formula and alternative formula modifications in relation to selected formula goals, and (2) to describe the pattern of revenue sharing allocations created by the present and selected modifications across jurisdictions with different social, economic, and political characteristics. The *principal formula goal* selected for this study is the design of a revenue sharing formula which does not discourage or distort local variations in financing and delivering services (neutrality). Five ancillary goals were also selected to be used in the design of formula modifications: (1) Fiscal need. The formula should allocate funds to jurisdictions in accordance with fiscal needs and responsibilities. (2) Reduced limits. The degree to which revenue sharing allocations are determined by arbitrary limits should be reduced. (3) Responsibility split. The formula should ensure splitting funds between state and local governments in a way which reflects variations in state-local fiscal responsibilities and needs. (4) Data availability. The formula should be designed to utilize reliable data elements and to reduce administrative cost. (5) Simplicity. The formula should be less complex.

The proposed modifications and selected formula goals are a response to certain identified non-neutral or distortive features of the formula. Research has been focused on four elements of the present intra-state allocation formula:

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[1] This paper is a summary of a report (published June 15, 1975) which was prepared with the support of a National Science Foundation grant (No. APR–7505247).

state-local split; the measurement of local fiscal effort; per capita limits; intra-county allocation process. Specifically, nine formula modifications were tested: (a) Two modifications of the state-local split; (b) A modified measure of fiscal effort as used in the inter-state allocation process; (c) Two alternative measures of fiscal effort as used in the intra-state allocation process; (d) Three modifications of per capita constraints; (e) One modification of the intra-county allocation process. Modifications were tested in four sample states in relation to selected measures of goal achievement. The modifications of the four formula elements which proved most successful in relation to formula goals were applied nationwide. The selected modifications, plus a composite, were analyzed in relation to goal achievement and social, economic, and political variables.]

DISCUSSION OF FORMULA ISSUES, MODIFICATIONS TESTED, AND GOAL ACHIEVEMENT [2]

State-Local Split

The uniform allocation of one-third of the state areas' revenue sharing entitlement to the state and two-thirds to general purpose local governments within the state appears unfair and unresponsive to the varying needs of state and local governments reflected by the prevailing diversity in financial relationships. Although the uniform one-third/two-third split roughly approximates the national distribution of general expnditures made by state and local governments, it does not reflect the national levels of financing these expenditures in 1971/72 local governments raised approximately 48% of total state and local general revenues.

The uniform split results in great diversity among states in the relative benefits received by state and local governments. In Hawaii, revenue sharing amounts to 10.2% of the general revenues of local government compared to 1.6% of the general revenues of state government. The ratio between these percentages amounts to 2.7% of revenues—resulting in a local preference ratio of 1.4 to 1. ship, local governments in New Jersey receive revenue sharing which amounts to 3.8% of general revenues compared to the state government share which amounts to 2.7% revenues—resulting in a local preferences ratio of 1.4 to 1.

Inasmuch as the present formula does not recognize existing or changing levels of financial responsibilities of state and local governments, there is a tendency for it to discourage shifts in the delivery or financing of services between state and local government.

Regardless of the rationale used to support the enactment of the apparently arbitrary state-local split, it is clear that a precedent has been set for an overall 2:1 preference ratio for local government. From a practitioner's point of view, any alternatives to the present state-local split should recognize this precedent.

Two feasible alternatives to the state-local split exist which maintain the present emphasis on the pass-through of aid to local government and also recognize the variety of fiscal arrangements existing between state and local governments across the nation. First, the proportion of state and local allocations can be determined by using the ratio of taxes (or revenues) raised by each—giving extra weight to locally raised revenues. A local weighting factor of 2.41 was determined to provide the 33.3% of the allocation to the states on a national basis. Second, the proportion can be determined by adjusting the states' present share of 33.3% by the number of percentage points that the state's level of financing is above or below the national level of financing. These methods were found to produce similar results, therefore, the weighting technique was used in the sample and national allocation analysis because it was considered to be more easily understandable than the second alternative.

The diversity among states in terms of the relative benefits received by state and local governments is decreased significantly under the alternative state-local split. The states of New Mexico and Massachusetts, which were at the extremes in terms of the local revenue preference ratio (relative to general revenues), changed significantly—under the alternative state-local split the ratio changes from 8.5 to 2.6 in New Mexico and from 1.9 to 2.5 in Massachusetts. In addition, the average ratio is decreased from 4.5 to 3.7 and the variation among ratios is significantly reduced.

The weighted state-local split is advanced as an improved method of dividing revenue sharing between state and local governments. The state-local split as proposed admittedly still does not have an entirely neutral effect on state or local government behavior. With a greater weight placed on locally raised reve-

[2] See Exhibit 1: Formula Modifications/Goal Achievement.

nues, there may be some incentive for the state to "shed" responsibilities since local governments receive a greater credit toward revenue sharing if the money is raised locally. Since it is a constant sum game between state and local government, this incentive would be small and could be minimized through strict maintenance of effort provisions. Under the proposed split, any relative increase or decrease in state financial responsibilities within a state will be recognized by a shift in revenue sharing; therefore, the split no longer discourages or distorts variations to as great as a degree as the present formula.

Fiscal Effort Definition

By limiting the definition of fiscal or revenue effort solely to taxes, the local fiscal assistance act has introduced forces of non-neutrality regarding the utilization of tax revenues as contrasted with non-tax revenues. This formula feature tends to discriminate against jurisdictions which (by choice or force of state mandate) [4, p. 248–249] are financing services by other means of public financing [3, p. 146]. Moreover, it offers a definite inducement to state and local governments, particularly those in greatest need of additional financial assistance, to alter their revenue structures by placing greater reliance on taxation and less on the use of non-tax resources than they otherwise would, all things being equal.

Among the major considerations affecting the composition of and change in state and local revenue or tax structures are: (1) regressivity vs. progressivity, (2) cost-benefit relationships, (3) exportability of incidence, and (4) net costs of public vs. private service performance. All of these considerations may be affected in some way by the current definition of fiscal effort in the local fiscal assistance act. A number of examples of such efforts may be given:

The exclusion of user charges may force increased reliance on income taxes or on less regressive sales taxes, or on more regressive property taxes.

User charges reflecting approximate cost/benefit relationships may be replaced by taxes less reflective of such relationships.

Jurisdictions obtaining revenues from charges for services (e.g., city parking, airports) rendered to non-residents may replace such charges with locally borne taxes.

The subsidy effect of revenue sharing may act as an incentive to retain or assume services which have been traditionally and/or more efficiently performed by the private sector.

If the allocation formula is to be neutral, the weights of these considerations should not be altered by revenue sharing. As the above examples indicate, however, the weights may be influenced. Thus, the issue to be resolved here concerns the identification of the alternative fiscal effort definition which would decrease such non-neutralities and more fully recognize the varying fiscal choices, burdens, and constraints of jurisdictions.

To remedy the non-neutral effects and inequities of the current fiscal effort measure, two modifications were tested which expanded the measure to include a number of non-tax general revenues. The first variation (Option 1) included all "general revenue own sources" excluding sale of property, interest earnings, miscellaneous general revenues, and current education charges. The scond variation (Option 2) while similar to Option 1 was more narrowly defined, excluding current charges raised from airports, miscellaneous commercial activities, hospitals, parking facilities, and water transport and terminal operations—primarily on the basis of the exportability of the incidence of such charges and on the basis of the quasi-private nature of such activities.

In the majority of sample states, both alternative measures showed improvement in the correlation between county area per capita revenue sharing and the 1966–67 ACIR measures of effort. The analysis showed that in relation to the present formula, Option 2: (1) more adequately recognizes the relative fiscal effort of recipient local jurisdictions, and (2) increases the neutrality of the revenue sharing formula in its effects on the financing of local government functions. These favorable results are produced without increasing the effects of the public vs. private enterprise non-neutrality and the inequities of counting revenues with commonly exported incidence.

Per Capita Constraints

The per capita constraint features of the revenue sharing formula have evoked strong criticisms on the grounds that they distort the intended effects of the three factor formula by depriving high tax and/or low income units of their "fair" entitlements and that they provide revenue sharing windfalls for low tax and/or high income jurisdictions. Accordingly, the 145% ceiling is attacked because it arbitrarily truncates entitlements to some jurisdictions which, on the basis of the three factors embodied in the formula, are deemed to have greater revenue sharing needs than jurisdicitons whose allocations fall naturally at or close to the 145% limit. Conversely, jurisdictions whose allocations are raised to the 20% minimum level or floor are viewed as receiving funds in excess of real needs—at the expense of allocations which should have gone to more deserving units of local government [1, p. 64]. The perception of many local as well as state officials interviewed is that the limits are "unfair" and work to at least partially abort the intended effects of the basic formula. The effects of the per capita constraints are considered by many to consist of an artificial underpinning of marginal units of local governments through disproportionately high (in terms of the workings of the basic three factor formula) infusions of federal funds and a consequent discouragement of pending or anticipated consolidation moves [3, p. 169].

The consensus of critics of the constraints is fairly solid on the desirability of eliminating the 20% minimum limit. ACIR states that "the elimination of the 20% minimum local per capita allocation would go a long way toward neutralizing the influence of general revenue sharing on local government structure and tone up the equalizing tendency of the present local distribution formula" [1, p. 67]. ACIR, however, goes on to say that the 20% rule "has the distinct merit of spreading a modest portion of revenue sharing funds around, thereby creating wider political support for the program" [1, p. 70].

Considerably less agreement appears to exist on what to do, if anything, with the 145% limitation. Some opt for the elimination of the limit [3, p. 129], others would like to have it raised [4, p. 25], and still others insist on the need for its retention [1, p. 71]. Even those advocating its abolition are aware of the sometimes massive shifts of revenue sharing funds which would be engendered by the elimination of the limit.

In the sample states, units affected by the present minimum are slightly above average in relation to income in California, Georgia, and New York and are 200% of average per capita income in Indiana. In all states these units have adjusted taxes which are significantly below average (9–26% of average). A number of population groupings of jurisdictions affected by the 20% minimum per capita limit in each of the sample states receive over 200% of the average local government amount of revenue sharing per $100 adjusted taxes.

Jurisdictions in the sample states are constrained by the 145% ceiling primarily because of their relatively high taxes—only in New York State are the constrained units significantly below average in per capita income.

Two alternative settings of the *per capita* limits were tested within the four sample states. In the first instance, the 20% and 145% limits were expanded to 10% and 180% to determine how many and what type of units would be constrained at different levels. Secondly, the limits were removed completely and the three factor formula was allowed to take its course.

The analysis of the removal of the limits in the four sample states indicates that the 20% limit is an unnecessary safeguard against low per capita allocations. When allocations are determined in the absence of the minimum limit, amounts are produced for previously constrained units which represent proportions of revenues and expenditures comparable to those of previously unconstrained jurisdictions. At the other extreme, it was found that the 145% limit does in fact constrain units at a reasonable level and insures against providing excessively high allocations to industrial or commercial enclaves, resort communities, or high spenders. On the basis of the sample state analysis the 20% minimum limit was eliminated and the 145% limit was retained for the national analysis.

Intra-County Formula

The present formula divides the county area allocation as follows:

1. Indian tribes and Alaskan native villages receive funds based upon the ratio of their population to the total county area population.

2. The county government, townships as a group, and all other units of local government as a group share the remainder on the basis of each group's respective share of total adjusted taxes in the county.

3. Following this three-way split (or two-way split in counties without townships), the components of each group divide their allocation on the basis of the three factor formula (subject to the per capita, 50%, and $200 constraints).

The purpose of the existing split based on adjusted taxes was an attempt to take into account the diversity of relative roles of local government and to avoid double counting in overlapping jurisdictions.

Intensive analysis of the impact of the revenue sharing formula on the local governments in Monroe County, New York has shown the existence of inequities and non-neutralities fostered by the process of separately grouping townships and municipalities [2].

Inequities are created by the failure of the formula to utilize the *income factor* in the competition of municipalities against townships for revenue sharing funds. Municipalities with a combined "tax effort" considered above that of the towns receive their group allocation without consideration being given to such effort. Tax effort reenters the picture once the group allocation has been made, but by that time its impact has been significantly reduced. This inequity, of course, is reversed wherever townships, as a group, exhibit a greater tax effort than municipalities.

The intra-county split also introduces non-neutralities. Whichever group receives the largest allocation in relation to income will act as a magnet for high tax effort jurisdictions in the opposite group. By changing its corporate status from a city to a town, the city of Rochester, New York could enhance its revenue sharing allocation by over 15% [4, p. 248]. In other counties, the incorporation of a township into a city may have similar revenue consequences.

An alternative which treats townships and municipalities as equal competitors for funds remaining after the determination of the Indian and county government shares was tested in the sample states. "Adjusted taxes" was used to determine the relative shares of the county government and all other units of local government and then the three factor formula was used to divide the funds among the local units of government within the county. Through this modification, townships and municipalities in the same county area will now receive identical amounts of revenue sharing if they have equal amounts of population, per capita income, and adjusted taxes.

After reviewing the rather minimal changes in the sample township states of Indiana and New Yorn, it is apparent that the revised intra-county allocation procedure recognizes the relative roles of the governments and avoids double counting in overlapping jurisdictions without distorting overall jurisdictional allocations. Accordingly, the revised intra-county allocation procedure is advanced as an improved method because it eliminates any inequities caused by the absence of the income factor in the present procedure and it eliminates any biases which are caused when a jurisdiction could enhance its revenue sharing allocation solely by changing corporate status.

Composite

In addition to testing each modification separately, they were also tested as a composite for the sample states and the country. The impact of each was detailed separately so that policy-makers have a basis for picking and choosing either one or more of the modifications. However, these modifications work most successfully in combination.

After analysis of the composite modification in the sample states, it is concluded that the composite modification:

1. Recognizes variations in state-local fiscal responsibilities.
2. Substantially decreases the number of units affected by limits (by 80%).
3. Provides low tax areas (previously affected by the 20% minimum) with an amount of revenue sharing which is more commensurate with their needs (i.e., in terms of revenue sharing as a percentage of revenues and expenditures).
4. Continues to constrain high tax areas.

In addition, by definition the composite modification:

1. Increases the comprehensiveness of the fiscal effort measure-decreasing the inequities and non-neutralities inherent in the present measure which does not adequately reflect fiscal need.
2. Treats units equally (in terms of the formula's data elements, etc.), regardless of corporate status.

NATIONAL DISTRIBUTIONAL EFFECTS OF PRESENT AND MODIFIED FORMULAS

National Overview

Nationally. each of the modifications produces changes in distributional patterns from the present which vary considerably in magnitude. The state-local split modification produces the most significant changes among all individual modifications—primarily between state and local governments within state areas. and in low income, non-white, and Spanish-American areas. Changes produced by the fiscal effort modification are less significant: there is an overall shift to municipalities, and a small increase in the number of units affected by formula limits. Under the per capita modification there is a shift of revenue sharing from townships to counties and municipalities and most major cities gain. The intra-county formula modification produces virtually no changes on a national basis from present patterns. The composite modification results in the most significant changes from the present formula patterns. As expected, many of the effects produced by the individual modification appear again in the composite national test.

Present Formula [3]

Highlights of the distributional effects of the present formula are as follows:

Individual states show a considerable difference in per capita amounts received—with the highest per capita state receiving nearly twice as much as the lowest.

Nearly all state governments receive about ⅓ of revenue sharing, and most local governments within states receive nearly ⅔ of revenue sharing.

Among all units, municipalities receive the largest share of revenue sharing.

Nearly 15,000 jurisdictions are affected by the current formula's limits. The 20% minimum limit affects the most units, particularly townships.

The nation's largest and smallest county areas receive the highest per capita revenue sharing allocations (relative to all county areas).

Metropolitan areas receive a slightly higher per capita allocation than non-metropolitan areas, but non-metropolitan areas receive higher allocations per $1,000 income and per $100 adjusted taxes.

The present formula is significantly income redistributive—using a national index for local allocations the poorest areas receive per capita allocations which are 40 points higher than the richest areas, 150 points higher per $1,000 income, and 304 points higher than per $100 adjusted taxes.

County areas and municipalities with high unemployment are favorably affected.

State-Local Split [3]

Significant differences in distributional effects between present allocations and the allocations created under the alternative state-local split may be highlighted as follows:

The total percentage of revenue sharing received by state governments increases to 36.02%—an increase of approximately 2 percentage points in the state government's share of statewide revenut sharing. However, 17 state governments receive less than a ⅓ split of revenue sharing.

Township governments' share of revenue sharing increases, while the amount distributed to other local governments decreases.

Only about half as many muncipalities are affected by the 50% limit (when also receiving an amount more than the 20% per capita minimum)—729 as opposed to 1,414 under the current.

Major cities receive slightly smaller per capita allocations on the average—although 26 of these cities receive higher per capita allocations.

On a local basis, metropolitan areas significantly increase their per capita allocation over non-metropolitan areas. On a local/state basis, however, metropolitan and non-metropolitan area per capita allocation differences virtually disappear.

County and municipal areas with high percentages of non-whites and Spanish-Americans receive less revenue sharing directly, although these losses are offset by corresponding increases in revenue shares for the parent states of those areas and municipalities.

This formula produces patterns which are somewhat less income redistributive—the poorest areas receive less revenue sharing directly, this being offset by increases to parent state governments.

Fiscal Effort Definition [3]

Differences in distribution effects created by the fiscal effort modification may be highlighted as follows:

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[3] See supportive exhibits for detail concerning selected distributional effects of all modifications in relation to the present formula.

Nine state governments lose a small amount of revenue sharing.

As a group, counties, townships, and Indian tribes lose revenue sharing, but municipalities gain.

A slightly larger number of jurisdictions are affected by the $200 limit, 20% minimum, and 50% limit (where 50% is less than or equal to the 20% limit).

Major cities receive a slightly higher per capita allocation on the average—with increases in 28 of the major cities.

The smallest (under 25,000) and largest (500,000 and over) county areas' units receive somewhat smaller amounts of revenue sharing. Municipal areas under 2,500 and over 500,000 receive less revenue sharing.

Per Capita Modification[3]

Significant differences in distributional effects under the per capita limits modification are as follows:

Counties and municipalities gain revenue sharing—townships lose.

One-third as many units are affected by formula limits: 20% units are eliminated; 145% units are increased slightly; one-half as many 50% units; and twice as many $200 units.

Most major cities gain revenue sharing.

Intra-County Modification[3]

The differences in distributional effects created by the intra-county modifications were relatively minor:

Revenue sharing to municipal areas increases slightly—while townships decline slightly.

Substantially fewer townships (—556) are affected by the 20% minimum.

A greater number of towns (+203) are affected by the 50% limit (when also receiving an amount more than 20% per capita minimum).

Composite Modification[3]

Significant differences created under the composite modifications are:

State governments generally gain revenue sharing. Overall, the states' share increases by two points—to 36% of statewide revenue sharing.

Far fewer jurisdictions are affected by formula limits (4,200 as opposed to 14,913 presently).

County areas over 250,000 in population gain, while those under 250,000 lose. Municipal areas over 2,500 gain, while those under 2,500 lose.

Per capita revenue sharing increases in 31 of the major cities, causing the average to increase slightly.

Non-metro, low income, non-white, and Spanish-American areas, lose revenue sharing on a strictly local basis, but when pro-rated overlying county and state shares are included, there is little change from present.

The differences in distributional effects between present allocations and allocations created under the composite formula modification are primarily due to the state-local split modification. In county areas, the state-local split was the major determinant of changes in all social, political, and economic variables analyzed, with the exception of the fiscal effort modification which played a significant role in decreasing allocations to areas with populations under 10,000, increasing allocations to areas with populations of 250,000-500,000 and reducing allocations to areas with high unemployment.

Distributional changes in municipal areas were similarly influenced by the state-local split; however, the fiscal effort modification had a greater influence in relation to population size. These two modifications generally had opposing effects—with the fiscal effort modification increasing allocations to areas between 2,500–100,000 in population. The net effect in the composite is that increases to municipal areas over 500,000 in population are due to the state-local split, while increases to areas between 2,500 and 100,000 and decreases to areas under 2,500 are due to the fiscal effort modification.

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[3] See supportive exhibits for detail concerning selected distributional effects of all modifications in relation to the present formula.

EXHIBIT 1.—FORMULA MODIFICATIONS/GOAL ACHIEVEMENT

Goals	Formula modifications affecting goal achievement									
	State-local split		Fiscal effort			Per capita limits				
				Intra-State						
	± Average	Weighted	Inter-State	Option 1	Option 2	10 to 180 percent	0 to 145 percent	Re-moved	Intra-County	Com-posite
Principal goal:										
1. Neutrality	+	+	+	+	+	+	+	+	+	+
Ancillary goals:										
2. Fiscal need	+	+	+	+	+	+	+	+	+	+
3. Reduced limits	+	+	0	–	–	+	+	+	+	+
4. Responsibility split	+	+	0	0	0	0	0	0	0	+
5. Data availability	+	+	+	+	+	+	+	+	+	+
6. Simplicity	+	+	–	–	–	0	0	+	+	+

EXHIBIT 2.—NATIONAL DISTRIBUTIONAL EFFECTS OF PRESENT FORMULA AND MODIFIED FORMULAS, 1972

Selected distributional effects	Present ORS formula	Formula modifications				
		State/local split	Fiscal effort definition	Per capita limits	Intra-county	Composite
1. Percent distribution by type:						
State government	33.91	36.02	33.83	33.92	33.91	36.00
Local government	65.95	63.85	66.01	65.94	65.94	63.86
Counties	25.37	24.18	24.24	25.63	25.39	23.42
Municipalities	35.64	34.56	36.97	35.94	35.74	36.20
Townships	4.94	5.11	4.80	4.37	4.81	4.24
Indian tribes	.12	.10	.11	.12	.12	.10
2. Per capita revenue sharing by type:						
State government	$8.80	$9.34	$8.77	$8.80	$8.80	$9.34
Local government (average)	9.70	9.40	9.71	9.70	9.70	9.40
Counties	7.45	7.10	7.12	7.52	7.45	6.88
Municipalities	14.18	13.76	14.71	14.31	14.21	14.41
Townships	5.62	5.82	5.47	4.98	5.50	4.83
Indian tribes	21.00	18.34	20.62	21.06	21.01	17.99
3. Number of units affected by limits:						
20 percent (total)	9,173	9,188	10,556	NA	8,712	NA
County areas	6	8	5	NA	8	NA
Municipalities	3,124	3,149	3,549	NA	3,217	NA
Townships	6,043	6,031	7,002	NA	5,487	NA
145 percent (total)	2,174	2,177	1,860	2,225	2,229	1,946
County areas	629	630	543	658	633	574
Municipalities	1,112	1,113	997	1,125	1,070	981
Townships	433	434	320	442	526	391
$200 (total)	595	591	639	1,263	594	1,408
Municipalities	268	276	283	565	272	689
Townships	327	315	356	698	322	719
50 percent (total)[1]	2,971	2,345	2,789	1,588	3,137	846
Municipalities	1,654	996	1,468	1,412	1,639	638
Townships	1,317	1,349	1,321	176	1,498	208
All limits (total)	14,913	14,301	15,844	5,076	14,672	4,200
Percent of all units	38	37	40	13	37	11

[1] Excludes counties affected by 50-percent limit.

EXHIBIT 3.—REVENUE SHARING PER CAPITA TO COUNTY AREAS IN RELATION TO SELECTED SOCIAL AND ECONOMIC CHARACTERISTICS

[Indexes: U.S. total=100]

County area characteristics	Direct local allocation: Present	Direct local allocation: State/local split	Direct local allocation: Fiscal effort definition	Direct local allocation: Per capita limits	Direct local allocation: Intra-county	Direct local allocation: Composite	Local plus overlying State allocation[1]: Present	Local plus overlying State allocation[1]: State/local split	Local plus overlying State allocation[1]: Fiscal effort definition	Local plus overlying State allocation[1]: Per capita limits	Local plus overlying State allocation[1]: Intra-county	Local plus overlying State allocation[1]: Composite
U.S. total	$17.19	$16.65	$17.09	$17.07	$17.19	$16.54	$25.92	$25.98	$25.82	$25.80	$25.92	$25.87
Metro/nonmetro:												
Within metro area	101	103	100	100	101	103	100	100	100	100	100	100
Outside metro area	99	94	100	100	99	95	99	100	100	100	99	100
Population size (thousands):												
1,000 and over	113	120	112	114	113	120	110	109	109	111	110	109
500 to 999	96	100	93	93	96	96	98	97	97	96	98	95
250 to 499	94	94	97	95	95	97	95	95	97	95	95	97
100 to 249	93	91	95	93	93	92	94	94	95	94	94	95
50 to 99	92	86	95	92	92	88	94	95	97	95	94	97
25 to 49	96	89	97	97	96	91	97	98	98	97	97	99
10 to 24	106	100	105	107	106	98	104	105	103	105	104	104
Under 10	116	114	111	117	116	109	111	111	107	111	111	108
Per capita income:												
$4,000 and over	70	77	70	69	70	75	80	79	80	79	80	78
$3,500 to $3,999	104	113	101	103	104	111	105	105	103	104	105	103
$2,500 to $3,499	99	99	101	100	99	100	98	98	99	99	98	99
$2,000 to $2,499	104	94	104	105	104	94	103	104	103	103	103	103
Under $2,000	110	91	108	111	110	89	109	111	107	109	109	110
Percent nonwhite:												
50 and over	101	75	100	101	101	74	123	122	123	123	123	122
25 to 49	122	107	122	123	122	107	115	114	115	115	115	114
15 to 24	110	112	109	112	110	113	106	107	106	107	106	107
5 to 14	93	96	94	94	93	96	95	95	95	95	95	95
Under 5	95	97	95	93	95	96	96	97	96	96	96	96

[1] Overlying State allocation prorated on the basis of population.

Note: Indian tribes and county areas for which there was no socioeconomic data available are excluded. (Differences in the U.S. totals of local plus overlying State are due to rounding involved in the prorating process.)

EXHIBIT 4.—REVENUE SHARING PER $1,000 INCOME TO COUNTY AREAS IN RELATION TO SELECTED SOCIAL AND ECONOMIC CHARACTERISTICS—Continued

[Indexes: U.S. total=100]

County area characteristics	Direct local allocation: Present	Direct local allocation: State/local split	Direct local allocation: Fiscal effort definition	Direct local allocation: Per capita limits	Direct local allocation: Intra-county	Direct local allocation: Composite	Local plus overlying State allocation [1]: Present	Local plus overlying State allocation [1]: State/local split	Local plus overlying State allocation [1]: Fiscal effort definition	Local plus overlying State allocation [1]: Per capita limits	Local plus overlying State allocation [1]: Intra-county	Local plus overlying State allocation [1]: Composite
U.S. total	$5.51	$5.34	$5.48	$5.47	$5.51	$5.30	$8.31	$8.33	$8.28	$8.27	$8.31	$8.29
Metro/nonmetro:												
Within metro area	91	93	90	90	91	93	90	90	90	90	90	90
Outside metro area	123	117	123	123	123	118	123	124	123	123	123	124
Population size (thousands):												
1,000 and over	96	102	95	97	96	102	93	93	93	94	93	93
500 to 999	83	86	80	80	83	83	84	84	82	82	84	82
250 to 499	91	90	93	91	91	93	91	91	93	92	91	93
100 to 249	96	93	97	96	96	95	97	97	98	97	97	98
50 to 99	107	100	110	107	107	103	110	110	112	110	110	112
25 to 49	123	115	125	124	123	116	124	126	126	125	124	127
10 to 24	149	140	147	150	149	137	146	148	145	147	146	146
Under 10	164	161	157	165	164	154	156	157	152	157	156	153
Per capita income:												
$4,000 and over	48	53	48	48	49	52	55	55	55	55	56	54
$3,500 to $3,999	87	94	84	86	87	92	87	87	85	86	87	86
$2,500 to $3,499	102	101	104	103	102	103	101	101	102	101	101	102
$2,000 to $2,499	142	129	142	143	142	128	140	141	140	141	140	141
Under $2,000	198	165	195	200	198	161	196	200	194	197	196	198
Percent nonwhite:												
50 and over	128	96	128	129	128	95	157	155	156	157	157	155
25 to 49	141	124	141	142	141	124	133	131	133	133	133	131
15 to 24	104	106	104	106	104	107	101	101	100	102	101	102
5 to 14	86	89	87	87	86	90	88	88	88	88	88	88
Under 5	100	102	100	99	100	102	102	102	101	101	102	101

[1] Overlying State allocation prorated on the basis of population.

Note: Indian tribes and county areas for which there was no socio-economic data available are excluded. (Differences in the U.S. totals of local plus overlying State are due to rounding involved in the prorating process.)

EXHIBIT 5.—REVENUE SHARING PER $100 ADJUSTED TAXES TO COUNTY AREAS IN RELATION TO SELECTED SOCIAL AND ECONOMIC CHARACTERISTICS

[Indexes: U.S. total=100]

County area characteristics	Direct local allocation						Local plus overlying State allocation [1]					
	Present	State/local split	Fiscal effort definition	Per capita limits	Intra-county	Composite	Present	State/local split	Fiscal effort definition	Per capita limits	Intra-county	Composite
U.S. total	$16.08	$15.57	$16.09	$16.07	$16.08	$15.57	$24.25	$24.31	$24.31	$24.28	$24.25	$24.35
Metro/nonmetro:												
Within metro area	81	83	81	81	81	83	81	81	81	81	81	81
Outside metro area	170	163	170	170	170	162	171	172	170	170	171	171
Population size (thousands):												
1,000 and over	67	72	66	68	67	71	65	65	64	65	65	64
500 to 999	77	80	76	76	77	78	78	78	78	78	78	78
250 to 499	105	105	108	105	106	107	106	106	108	106	106	107
100 to 249	123	120	124	122	123	121	125	124	125	124	125	125
50 to 99	156	147	161	156	156	150	161	162	164	160	161	164
25 to 49	192	179	194	192	192	180	194	196	195	194	914	196
10 to 24	213	199	208	213	213	195	209	210	205	208	209	207
Under 10	183	179	173	182	183	170	174	175	167	173	174	168
Per capita income:												
$4,000 and over	50	55	50	49	50	53	57	56	57	56	57	55
$3,000 to $3,999	65	71	64	65	65	70	66	66	65	66	66	65
$2,500 to $3,499	112	111	113	112	112	112	111	110	111	111	111	111
$2,000 to $2,499	211	191	210	211	210	190	208	210	207	208	208	208
Under $2,000	354	295	346	354	354	285	350	357	344	350	350	351
Percent nonwhite												
50 and over	81	60	80	81	81	59	99	98	98	98	99	97
25 to 29	122	108	121	122	122	107	115	114	114	115	115	113
15 to 24	81	83	80	82	81	83	78	79	78	79	78	79
5 to 14	89	92	89	89	89	91	90	90	90	90	90	90
Under 5	125	127	126	125	125	129	127	127	128	127	127	128

[1] Overlying State allocation prorated on the basis of population.

Note: Indian tribes and county areas for which there was no socio-economic data available are excluded. (Differences in the U.S. totals of local plus overlying State are due to rounding involved in the prorating process.)

EXHIBIT 6.—PER CAPITA REVENUE SHARING TO SELECTED CITIES, 1972

Population rank: City area	Direct local allocation						Local plus overlying State allocation [1]					
	Present	State local split	Fiscal effort definition	Per capita limits	Intra-county	Composite	Present	State/local split	Fiscal effort definition	Per capita limits	Intra-county	Composite
1: New York	$26.99	$29.11	$27.49	$27.45	$26.96	$30.18	$26.99	$29.11	$27.49	$27.45	$26.96	$30.18
2: Chicago	18.48	19.12	17.09	19.46	18.55	18.67	21.12	21.86	19.56	22.24	21.20	21.65
3: Los Angeles	11.26	12.25	11.04	11.30	11.26	12.05	23.22	25.26	22.37	23.30	23.22	24.15
4: Philadelphia	22.65	20.25	22.65	22.65	22.65	20.25	22.65	20.25	22.65	22.65	22.65	20.25
5: Detroit	24.30	23.04	24.30	24.30	24.30	23.04	28.71	27.22	28.01	28.71	28.71	27.03
16: Boston	27.91	30.19	27.91	27.91	27.91	30.19	27.91	30.19	27.91	27.91	27.91	30.19
17: Honolulu	18.95	12.48	19.05	18.95	18.95	12.54	18.95	12.48	19.05	18.95	18.95	12.54
18: Memphis	18.10	16.21	19.24	18.14	18.10	17.26	25.51	22.85	26.02	25.57	25.51	23.27
19: St. Louis	20.22	20.83	20.22	20.22	20.22	20.83	20.22	20.83	20.22	20.22	20.22	20.83
20: New Orleans	26.68	22.46	30.92	28.71	28.68	24.23	28.68	22.46	30.92	28.71	28.68	24.23
31: Cincinnati	18.17	19.73	18.60	19.12	18.24	20.94	23.38	25.39	22.66	24.60	23.45	26.02
32: Minneapolis	12.94	12.17	13.43	13.31	13.00	12.94	19.08	17.95	17.68	19.63	19.17	17.46
33: Nashville-Davidson	16.43	14.71	16.20	16.47	16.43	14.54	16.43	14.71	16.20	16.47	16.43	14.54
34: Fort Worth	11.62	11.31	12.91	11.63	11.62	12.59	13.71	13.34	14.92	13.72	13.71	14.59
35: Toledo	11.86	12.88	13.06	12.48	11.87	15.08	15.06	16.36	16.57	15.85	15.08	19.33
46: St. Paul	13.72	12.90	13.81	14.11	13.78	13.30	19.38	18.22	18.34	19.93	19.47	17.77
47: Norfolk	21.99	20.58	21.99	21.99	21.99	20.58	21.99	20.58	21.99	21.99	21.99	20.58
48: Birmingham	18.34	12.85	17.13	18.36	18.34	12.02	27.93	19.57	25.96	27.96	27.93	18.82
49: Rochester	10.44	11.26	12.35	10.61	11.82	15.17	16.91	18.23	17.45	17.19	18.28	21.77
50: Tampa	18.86	16.78	20.59	18.88	18.86	18.34	27.84	24.77	28.61	27.87	27.84	25.51

[1] Overlying county prorated on the basis of population.

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Chairman BOLLING. Thank you.

Next, Mr. Robert Strauss, Joint Committee on Internal Revenue Taxation.

STATEMENT OF ROBERT P. STRAUSS, STAFF ECONOMIST, JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, U.S. CONGRESS

Mr. STRAUSS. I have a longer statement.

Chairman BOLLING. Just proceed as you wish.

Mr. STRAUSS. I appreciate the opportunity to testify on the results of my recently completed study of the within-State allocation formula. As perhaps you know, I have worn three hats with regard to general revenue sharing. As an academician at the University of North Carolina, I have studied and written on State and local finance; as an assistant to the Deputy Secretary of the Treasury during the period of congressional consideration, I worked very closely on the legislation that was enacted; and now as a staff economist with the Joint Tax Committee I have some responsibility for the act.

The research which I recently completed involves a narrow, rather technical problem in the bill which nonetheless has important ramifications for local allocations in several States. In particular, it deals with the manner in which the so-called floor is actually provided to localities. Depending on how one interprets that section of the act, one may achieve rather markedly different allocations to township governments in the Midwest. The purpose of the project was to examine the differences which result from differences in interpretation; that is, there is a difference in the way the 20-percent floor was implemented in the computer allocation program I worked on at Treasury during the development of the legislation, and the one finally used by the Office of Revenue Sharing and this affects the dollar allocations.

In order to focus these research results, let me review very broadly the way the within-State allocation formula works. First you allocate among county geographic areas, and then, second, within. For each county area its population, tax effort, and inverse per capita income are multiplied together to form a weight, or factor, and the weights for the State totaled. The initial or raw allocation to each county area is its proportion of weights allocated across the State. If an area grant exceeds the ceiling, the area is put at the ceiling and the excess shared proportionally among other areas of the State. If the grant to an area is below the floor, the area receives the floor amount, and the remaining unconstrained areas are proportionately reduced; we have in effect a leveling of allocations because of the floor and ceiling.

Within each county area the money must be divided among actual units, and this is done in two steps.

First, the area amount is divided among types of governments on the basis of taxes raised. If the county government raised 20 percent of all area taxes, it would receive 20 percent of the area amount. If cities in the area raised 30 percent they would receive 30 percent, and so forth.

Second, division of the amount to cities is made on the same basis as among the county areas, that is, population, tax effort and inverse per capita income are multiplied together to form a weight. The initial or raw grant to each city is then its proportion of the weights times the dollar amount available to all cities.

It is at this point—allocation to individual cities and townships—that differences in the interpretation of the floor occur.

The problem in a nutshell is this: In those county areas which we brought up the floor, there may not be subsequently enough money to bring cities or townships in that area up to the floor. Yet, the act provides that each local government should get the floor, or subsequently, no more than 50 percent of taxes and transfers.

There are two solutions to this possibility of a shortfall in allocations. One can find funds from unconstrained governments, or leave such places below the floor.

The Office of Revenue Sharing decision has been to finance the shortfalls by, in effect, reducing grants to other localities. The original interpretation of the formula as embodied in the Senate Finance and Conference Committee reports was to leave such shortfalls in place. In fact, it was intended that the division of the area amount among types of government on the basis of taxes was to be controlling. That is, the amounts provided for each type of unit were to be used to bring local units up as close to the 20 percent floor as such amounts would permit. It was not intended that funds be obtained from other areas to raise places to the 20 percent floor if this would result in a larger share of the county area's funds going to a type of locality than the initial functional division.

The 20 percent floor was a secondary rule, a smoothing function and was not to override the basic division based on importance of types of government.

The impact of the two interpretations is displayed in table 1 of my prepared statement, which shows by type of government the changes in aggregate entitlements. The percentages for the townships are particularly interesting. They show that if one goes from the Office of Revenue Sharing interpretation back to that used in the committee reports, Midwest townships would receive substantially less. For example, Illinois townships would get 32 percent less. This money spills over to counties and cities 4.6 percent and 4.8 percent respectively. You can go down and look at other States, Indiana, Kansas, and so forth, you see similar substantial changes in amounts for townships.

Many disinterested observers of local government were dismayed by the relatively large revenue sharing allocations to Midwest townships because they are not particularly active forms of local government. What table 1 indicates is that this shoring up of such units results in main from the interpretation of the floor which ORS made. As I understand it, the Illinois legislature was about to abolish the township form of government in late 1972, but was unable to accomplish this when the large allocations were made.

Another point worth noting from table 1 is that although the changes for Midwest townships might be substantial, the gains for cities and counties are much more modest. As I mentioned, Illinois suffers a 32-percent loss in its townships, but the changes in the counties and cities are much more modest.

Thus, while the effects for Midwest townships were marked, the overall amounts to less than $30 million a year. I hasten to add that the effect on the New England townships is quite different; in New Hampshire and Vermont they actually gain 2 percent. This reflects the fact that they are much more active forms of government in that part of the country.

It should be observed that the shortfalls below 20 percent in the committee report were known at that time, but in light of the low tax effort and correspondingly low level of fiscal activity, and/or high per capita income, were thought to be acceptable. By and large, the county governments in such 20 percent areas are the most active forms of local government and appropriately should receive more revenue sharing funds.

By way of summary, I found that much of the Midwest township problem is due to the post-enactment interpretation of the floor provision of the bill. Other interpretations are available and lead to allocations that would seem to make more sense.

[The prepared statement of Mr. Strauss follows:]

PREPARED STATEMENT OF ROBERT P. STRAUSS [1]

Congressman Bolling, and Members of the Committee, I appreciate the opportunity to testify on the results of my recently completed study of the within-State allocation formula. As perhaps you know, I have worn three hats with regard to general revenue sharing: as an academician at the University of North Carolina, I have studied and written on State and local finance; as an assistant to the Deputy Secretary of the Treasury during the period of congressional consideration of general revenue sharing; and now as a staff economist with the Joint Tax Committee which has some responsibilities for the act. While at Treasury, I was involved in the development and evaluation of various formulas and also worked on problems relating to data and administrative matters.

The research which I recently completed involves a narrow, rather technical problem in the bill which nonetheless has important ramifications for local allocations in several States. In particular, it deals with the manner in which the so-called "floor" is actually provided to localities. Depending on how one interprets section 107 (a) and (b) of the act, one may achieve rather markedly different allocations to township governments in the Midwest. The purpose of the project was to examine these differences which result from differences in the original "floor" interpretation as reflected in the Finance and Conference

[1] The research summarized resulted from a study done at the University of North Carolina, where the author is Associate Professor of Economics, with the support of the National Science Foundation under grant SSH74–22662. However, any opinions, findings, conclusions or recommendations expressed are those of the author and do not necessarily reflect the views of the National Science Foundation, or the Joint Committee on Internal Revenue Taxation.

Committee reports (the estimated allocations) and the one ultimately arrived at by the Office of Revenue Sharing in December 1972. That is, there is a difference in the way the 20-percent floor was implemented in the computer allocation program I worked on at Treasury during the development of the legislation, and the one finally used by the Office of Revenue Sharing.

In order to focus the research results, allow me to first review broadly the way the within-State allocation formula works:

Allocation among county geographic areas.—There is in each State a local amount to be distributed, first among county geographic areas, and then within each county geographic area. For each county area, its population, tax effort, and inverse per capita income are multiplied together to form a weight or factor, and the weights for the State totaled. The initial or "raw" allocation to each county area is its proportion of weights applied to the amount to be shared. If an area grant exceeds the ceiling, the area is put at the ceiling and the excess shared proportionately among other areas. If the grant to an area is below the floor, the area receives the floor amount, and the remaining unconstrained areas are proportionately reduced.

Allocation within each county area.—With a county area amount so determined, the money must be divided among actual units of government. This is done in two stages:

First, the area amount is divided among types of governments on the basis of taxes raised by each. So, if the county government raised 20 percent of all taxes in the county area, it would receive 20 percent of the area amount. If cities in the area raised 30 percent of all taxes in the area, then they as a whole would receive 30 percent of the area grant, and so forth.

Second, division of the amount to cities is made on the same basis as the allocation among county areas. That is, city population, tax effort, and inverse per capita income are multiplied together to form a weight. The initial or "raw" grant to each city is then its proportion of the weights times the dollar amount available to all cities.

It is at this point—allocation to individual cities and townships—that differences in the interpretation of the floor occur.

The problem in a nutshell is this: in those county areas which were brought up to the floor, there may not be sufficient funds to subsequently bring cities or townships in that area up to the floor. That is, the amount allocated to all cities or to all townships may not be large enough to bring places to the floor. Yet, the Act provides that each local government should get the floor, or subsequently, no more than 50 percent of taxes and transfers.

There are two solutions to this possibility of a shortfall in allocations. One can find funds from unconstrained governments or leave such places below the floor.

The Office of Revenue Sharing decision has been to finance the shortfalls by, in effect, reducing grants to other localities. The original interpretation of the formula as embodied in the Senate Finance and conference committee reports was to leave such shortfalls in place. In fact, it was intended that the division of the area amount among types of government on the basis of taxes was to be controlling. That is, the amounts provided for each type of unit were to be used to bring local units up as close to the 20 percent floor as such amounts would permit. It was not intended that funds be obtained from other areas to raise places to the 20 percent floor if this would result in a larger share of the county area's funds going to a type of locality than the initial functional division on the basis of taxes raised provided. The 20 percent floor was a secondary rule, a "smoothing function" and was not to override the basic division based on importance of types of government. In this view, the excess amount to township problem should not arise.

The impact of the two interpretations is displayed in Table 1 which shows by type of government the changes in aggregate entitlements. The table shows that if one goes from the Office of Revenue Sharing interpretation back to that used in committee reports, townships in the midwest States would receive substantially less. In Indiana they would get 50 percent less, in Illinois 32 percent less, and so forth.

Many disinterested observers of local government were dismayed by the relatively large revenue sharing allocations to midwest townships, because they are not particularly active forms of local government. What Table 1 indicates is that this showing up of such units results in main from the interpretation of the floor which ORS made. As I understand it, the Illinois legislature was about to abolish the township form of government in late 1972, but was unable to accomplish this when the large allocations were made to these units.

Another point worth noting from Table 1 is that although the changes for midwest townships might be substantial, the gains for cities and counties are much more modest. In Illinois, the 32-percent loss for townships leads to only a 4.6-percent increase in entitlements for county governments and 4.8-percent increase in entitlements for cities. Thus, while the effects for midwest townships are marked, the overall amounts (less than $30 million/year) are small in relation to the overall program. I hasten to add that the effect on New England townships is quite different (in New Hampshire and Vermont, they actually gain two percent) which reflects the fact that they are fiscally important and have tax effort that is comparable to that of cities.

The research analyzed, then, involved, what to do when there was a shortfall of funds to meet the 20-percent requirement. Another change analyzed in the project involved the relationship between the 20-percent floor and the 50-percent maximum. The Act rather clearly states that the 20-percent rule should be applied first and the 50-percent second. To the extent that the 20 percent exceeds the 50 percent for a city, the county government benefits because it receives the resulting "excess." If the county government gets in excess of 50 percent, the resulting excess is to go to the State government.

The Office of Revenue Sharing, concerned that the reduction of unconstrained grants to finance shortfalls might be needlessly large if the 20 then 50 procedure were followed, decided to provide the *smaller* of the 20 or 50. This leads to smaller grants to county governments and smaller "excesses" or "bonuses" to the State. This is noticeable for South Carolina. Thus, you will note in Table 1 that the committee report interpretation, as compared to the Office of Revenue Sharing interpretation, could yield smaller grants to both counties and cities (South Carolina has no townships); the difference would accrue to the State government.

It should be observed that the shortfalls below the 20 percent in the committee report were known at that time, but in light of the low tax effort and correspondingly low level of fiscal activity, and high per capita income, thought to be acceptable. By and large, the county governments in such 20-percent areas are the most active forms of local government and appropriately should receive more revenue sharing funds.

By way of summary, I found that much of the "midwest township problem" is due to the post-enactment interpretation of the floor provision of the bill. Other interpretations are available and lead to allocations that would seem to make more sense.

TABLE 1.—PERCENT CHANGE IN GRANTS BY TYPE OF GOVERNMENT USING ORS SEQUENCE COMPARED TO COMMITTEE REPORT SEQUENCE [1]

State	Percent Counties	Percent Cities	Percent Townships
Alabama	1.50	-0.90	0
Alaska	-.26	-8.30	-22.78
Arizona	-.37	.30	0
Arkansas	.07	-.14	0
California	-.22	.33	0
Colorado	.42	-.23	0
Connecticut	0	3.04	-7.46
Delaware	5.94	4.65	0
District ot Columbia	0	0	0
Florida	.13	-.10	0
Georgia	.16	-.22	0
Hawaii	0	0	0
Idaho	.14	-.19	0
Illinois	4.62	4.84	-31.98
Indiana	5.02	6.63	-50.20
Iowa	.13	-.18	0
Kansas	2.33	.89	-25.77
Kentucky	-1.33	-.54	0
Louisiana	.75	-.62	0
Maine	-2.72	-3.52	3.06
Maryland	.06	-.58	0
Massachusetts	-1.22	-.20	-.23
Michigan	-1.94	5.45	-28.61
Minnesota	1.82	.27	-16.24
Mississippi	-.40	.82	0
Missouri	.02	.27	-6.04
Montana	.07	-.16	0
Nebraska	.53	.42	-14.31
Nevada	-0	-0	0
New Hampshire	-.13	-1.97	2.27
New Jersey	-2.36	2.92	-2.33
New Mexico	-.03	.03	0
New York	1.62	.29	-12.12
North Carolina	.62	-.73	0
North Dakota	.18	-.01	-.66
Ohio	2.85	5.12	-39.24
Oklahoma	1.24	-.79	0
Oregon	-.40	.24	0
Pennsylvania	-1.33	1.81	-4.03
Rhode Island	0	.79	-2.04
South Carolina	-1.31	-3.61	0
South Dakota	1.10	.55	-11.08
Tennessee	1.25	-.93	0
Texas	.22	-.13	0
Utah	-.18	.19	0
Vermont	5.31	-5.34	2.18
Virginia	-.02	.36	0
Washington	-1.26	1.04	-72.13
West Virginia	1.99	-2.11	0
Wisconsin	2.87	1.52	-22.74
Wyoming	.49	-1.47	0

[1] Percentage change is: ORS—Committee report over ORS.

Source; Robert P. Strauss, "The Impact ot Alternative Interpretations of the Floor and Ceiling Provisions of the State and Local Assistance Act ot 1972"; final report to National Science Foundation under Grant SSH74 (Chapel Hill, June 1975), table V–V.

Chairman BOLLING. Thank you.

Next is Mr. G. R. Stephens, University of Missouri. I think that I have to indulge in a little parochialism and express my pleasure that one of the witnesess is from my State.

STATEMENT OF G. ROSS STEPHENS, PROFESSOR OF POLITICAL SCIENCE, UNIVERSITY OF MISSOURI, KANSAS CITY, MO.

Mr. STEPHENS. And your constituent.

My part of the research project was to look at the State-local split, and make recommendations that adjust the one-third/two-thirds split in a manner that reflects the division of State and local responsibility for public service.

Now, this was interpreted to mean first, which level pays for public services; and second, which level actually delivers the services, or various combinations thereof. And to this end we investigated about a dozen measures—and experimented with several others.

But I think also, when we talk about the State-local split, we start in our research, at least, from conceptualization that State and local governments are not quite the same as the Federal and State levels in terms of the actual division between levels. The States and localities are part of a kind of interacting and interdependent fiscal-service-political mechanism that operates in each State with rather wide variations in State and local responsibility for public services, and/or State centralization, whatever term you use.

Local governments still have an important role to play, it is just not the same considering State-local as considering Federal-State in terms of the division. That is the purpose of the Federal arrangement so that we have leeway to allow the States to develop the kind of State-local system that they think they need.

General revenue sharing does not recognize the difference in State and local systems. The State-local split of moneys is not keyed to the performance of the two levels of government. There are some variations, but they don't relate significantly to the division in responsibility, however you measure it. We have tried a number of measures, and nearly all of them result in more money going to the State level of government, on the average; not necessarily for the individual States, however.

It (GRS) is also highly specific as to what level and what government gets the money, and that specifically doesn't conform in most cases to what the States and localities are doing.

Implicit in general revenue sharing is the assumption that we have a three-tier system of federal government, and I don't think that is quite the case, at least not legally. In some ways general revenue sharing violates some of the precepts of the federal system and constitutes a kind of fiscal and political wedge between State and local governments. I could say more about that, but I really don't want to get off, on tangents.

The present split does not relate to the situation in the average State in terms of performance as measured by financial and service responsibility; and in some cases it's rather inequitable. Relative to what the States and localities are doing, there is wide variation. Data for the average State is quite different from the national totals that we get from the Census Bureau, partly because the national totals are distorted by the two mega-States, New York and California, which also happen to be the most decentralized in terms of State-local service delivery.

The average State is responsible for about half of the State and local public service that is delivered, and it pays for approximately three-fifths of that State and local service. This varies from around one-fourth for a State like New York, to something like fourth-fifths for a State like Hawaii, depending again upon which measure we are talking about.

The major trend in the last 60 years, though, has been toward the exercising of greater State responsibility, State-level responsibility, in terms of paying for and delivering public service. Small States tend to have more centralized systems, large States tend to have more decentralized systems. A lot of the variation over three-fourths, in the kinds of State and local systems that exist in the 50 States are explained by things like population size, the State-local tax structure, and the State system of local government.

I don't know whether this indicates there are economies, or diseconomies in scale. It may well be so, but that is not a question we had time to investigate.

Our recommendations really come at three or four different levels, relative to the State-local split. The ideal way, if we consider State-local systems as being fairly unique in each State, would be to give—Federal moneys—to the State government and let the State do the reallocation. This is compatible with the Federal system. States supposedly have more knowledge about what their localities are doing than some of the Federal agencies. That is a hypothesis, too.

It would be more flexible in terms of how the money is being distributed. You might have pass-through provisions, or not, and it eliminates the problem, a very difficult problem, of defining what a general purpose government is. A municipality in one State may be quite different from one in another State, and even within the same State. Largely it would eliminate the need for ORS if you give the money to the States. This was one of the earlier GRS proposals.

I am not really suggesting this as something that I think you can get through Congress. The local governments would be very upset by this kind of approach. It might transfer some of the political squabbles from Congress to the State legislatures.

Our primary recommendation is to key the State-local split to State and local performance as measured by financial responsibility and service delivery. This would immediately cause a great deal of discontinuity in the program, but if phased in over a 5-year period; and if we assume that we are going to increase very gradually, like 4 percent a year, the amount that goes to States and localities, it would have relatively little effect upon local governments. And those which would be adversely affected would be the most inactive anyway.

There is a third level of recommendation that we make, and that is, if neither of the previous recommendations are politically feasible. It involves the development of two different algorithms that basically weight local expenditures or revenues as more important than State. Now, I have a little difficulty with this if the same service provided is by the State in Kansas and by the local government in New York; weighting it as twice as important because it is locally provided causes some real conceptual difficulties, and some other difficulties as well. But it does give you a one-third/two-third split, and allows variability up and down and around that (one-third) in some proportion, not directly related to what the States and localities are doing.

We have another set of recommendations that are really not part of the primary purpose of this project. One of them is to give greater consideration to what we are really doing when we define a general purpose government, partly because it is so different in different places.

And another involves the fact that general revenue sharing is a rather poor vehicle for compensating native Americans. The amounts they get are kicked back and forth by the interstate and intrastate allocations. The maintenance of effort provision is probably ineffective in the present law, partly due to inflation. The States can level off, or cut back their real efforts without violating that provision.

Also, there is some problem in legislation relative to State assumption of activities, new responsibility. We should give serious consideration, as was said yesterday, to using revenue effort instead of tax effort. Using revenue effort instead of tax effort is desirable because in many cases the States and localities that have diversified their revenue base are being penalized compared to those who use only the property tax or some other local tax.

Earlier I alluded to the wide difference in political acceptability of some of the things that we suggested, but it depends in part on what we consider in the decision matrix; whether the recommended changes are phased in or done immediately; or whether you have a gradual increase in the amount of money in revenue sharing as under present legislation.

Also, I suppose, looking simply at the number of governments lining up at the Federal Treasury, 800 to 1, I believe it is, localities to States. The States cannot expect very much. But if we also look at the role of the States in the Federal system we get a little different picture and a different problem of equity, relative to what the States and locals are doing, that is, how much of the service is being performed at the State level, either in terms of financial or service responsibility.

There are a couple of other things I could say, but I'm going to close by saying, general revenue sharing is for general support, general financial support, of some of the needs of State and local governments. I don't think we can solve all our social, and economic, and other problems in this one piece of legislation. It can't solve all our governmental problems. It can't be all things to all governments.

The problems of State and local governments are in many ways systemic, and it is very difficult to simply give the money to a locality without having it affect the way the State and local system operates. In a sense we are trying to treat them as symptoms when we give an arbitrary allocation—rather than treat the system because most States do pay for far more services than they deliver; and most localities deliver more than they pay for.

Nevertheless, I think general revenue sharing could be more effective by gearing the distributions to the system and/or to the performance of State and local governments. That's it.

[The prepared statement of Mr. Stephens follows:]

Prepared Statement of G. Ross Stephens

State Responsibility for Public Services

The basic focus of this research is the development of formula recommendations that adjust the present one-third state/two-thirds local split of General Revenue Sharing (Public Law 92–512) monies in a manner that fits the state/local division of responsibility for the delivery of public services in the individual states. Responsibility for service delivery is interpreted as the division between state and local governments in terms of: 1) which level pays for public services, 2) which level operates the service delivery system, and 3) various combinations thereof. To this end this project has investigated more than a dozen different measures of state responsibility and experimented with several others.

APPROACH

One of the differences between this research and some carried on elsewhere is the conceptualization of roles played by state and local governments in a federal system. This concept is also at variance with some of the ideas implicit in presentations before Congressional committees. Our construct might be loosely termed a "systems approach" to state and local governments and it is verified both by the data and by the constitutional and legal systems operating in the fifty states.

In a two-tier federal system such as we have in this country, the principal levels of government are the nation and the states. Local governments are dependencies of the state level in a legal-constitutional sense. They are part of a complex, interacting and interdepndent state/local political and fiscal-service governmental mechanism operating within each individual state. In other words, local governments are part of a state/local system, not separate levels of government in the same sense that applies to the nation and the states. Further, no two state/local systems are identical and they range from quite decentralized to balanced to rather highly centralized arrangements. Some have centralized, i.e., state level, fiscal systems with the bulk of the services delivered by local government. Others have mixed systems. Most states pay for more services than they deliver directly while most local governments deliver more services than they pay for.

Local governments have an important place in the system, but their position cannot be separated from the role of state government and the interaction of the state/local system. Nor are local governments necessarily "low man on the totem pole" when it comes to the interaction of the state/local system. They interact and influence the state, is agencies, and oher local governments through negotiation, representation, and political action.

The concept implicit in General Revenue Sharing and some of the more recent Federal grants is not derived from a systems viewpoint, but from an entirely different model. Possibly as the result of a history of Federal-State conflict and heavy political pressures on Congress for a larger local government share when present GRS legislation was passed, the construct implicit in General Revenue Sharing is of state and local governments that are distinctly separate levels and somewhat mutualy antagonistic and opposed. Politically and financially it is in the interest of local governments to make it appear that they are a maligned and downtrodden third level of government. This gives them more direct access to Federal funds than they would have if they had to fight it out within their own political system. They also have a more distant arbiter; one less familiar with the way individual state/local systems operate. This conceptualization of the roles played by state and local units does not fit either the data relative to service responsibility or their legal place in the system. The United States has not yet evolved a three-tier federal government and there is little reason to believe it will in the near future unless it does so by national fiat.

Another tenet of our political system is "local autonomy," but there is a very real problem in the determination of how local is local? This precept is usually invoked when interlevel conflict arises over jurisdiction and authority. In a two-tier federal arrangement it is up to the state level, through the interaction of its own system, to determine how local is local. Local unis compete with each other and with the state in the determination of this issue and the decisions are never entirely stable or clearly delineated. In one sense, the present one-third/two-thirds state/local split of GRS funds is an unwarranted Federal intrusion on a state/local political issue. An important purpose of a federal arrangement is to allow the states to develop state/local systems that fit their needs and political cultures.

GENERAL REVENUE SHARING

General Revenue Sharing is a truly radical alteration of the Federal grant system and in ways we don't always consider. It not only eliminates specificity and matching requirements, it is narrowly specific as to what individual governments receive and reverses the principal recipient level from state to local.

GRS drastically alters the manner in which Federal largesse is distributed. It eliminates any real attempt to achieve specific national goals unless general financial support of local and state governments is considered specific. Expenditure objects are no longer very important. Matching requirements and program conformity are done away with. In some ways it represents a delegation and potential redistribution of power to those governments so benefitted. In the past under our traditional categorical grant system, features like matching requirements and program conformity prodded the states and to a lesser degree the localities into updating their revenue, service, and administrative structures. No such pressures exist under GRS.

GRS is narrowly specific as to which levels and which governments get the Federal monies so distributed. If discretionary use of money is power, then this extremely complex formula represents a redistribution of power—one that is quite different from the systems which have evolved in the fifty states over the past six decades.

Compared to our traditional categorical grant system, GRS and recent block grants represent a reversal of recipient level from state to local. For the quarter-century between 1946 and 1971 ninety per cent of all Federal aids went directly to the state government in an average year. The states either spent the money directly or passed it on through to local governments depending upon the nature of the grant and the state/local system of government. Such a procedure allowed the state the flexibility to apply the monies at the level or to the government most appropriate for attaining program objectives. Under GRS this is not possible for most states given the rigid specification of recipient governments. Over time, this kind of specificity when coupled with the reversal of recipient level for block grants could force the states into a more decentralized mode.

Federal aids should be neutral relative to the system of state/local government under a two-tier federal arrangement. Giving most or all of the funds to local government is not a neutral stance. From this perspective, GRS not only violates some of the precepts of federalism; it constitutes a fiscal and political wedge between state and local governments. In the past, Federal aids have acted as a stimulus to both action and inaction on the part of state and local governments, depending upon circumstance. Giving most of the money to local governments may cause the state governments to ease up on their increasing financial support of local government, especially when the states themselves are being cut out of Federal programs. Most states have either balanced or centralized state/local systems and these are the ones affected by the reversal of recipient level. Moreover, state aid to local government is many times larger than Federal aid to localities. The leveling off or cutback of these subventions could lease local governments even more dependent upon their own limited resources and Federal generosity. With the advent of block grants and GRS, the Congress and the Executive branch have become the arena in which the states and their localities fight over state/local and interlocal allocation of Federal funds instead of the state level.

By undertaking the state/local and interlocal allocations, the national government seems to assume that we have a three-tier federal system with highly discrete state and local levels of government. And it is true that states allow discretionary activities on the part of local government, but so far those discretionary activities are at the pleasure of the state government and a result of the interaction of the state/local system. We have yet to establish a constitutionally defined third level even though some states have so-called "home-rule" local governments. If, on the other hand, it is a national policy to push the states into a decentralized mode and create a distinctly third level of government with major Federal subsidies to replace state aids, that should be a conscious and open policy decision.

MEASURING STATE/LOCAL PERFORMANCE

Nearly all of the methods available to measure the relative performance of state and local governments involve the analysis of revenues and expenditures for state and local governments. An almost infinite variety of measures can be devised, but the ones tried for this project seem to be most appropriate and have the fewest undesirable side-effects or secondary consequences. They also are the measures that have the least inherent bias either toward the state or local levels. One measure not used to analyze the state/local split is FTE state and local government employment. This was discarded almost before the research began as having a heavy local bias. Local services are very labor intensive whereas state government activities have more of a cash and capital input bias so total revenues and expenditures with certain modifications are utilized as performance measures. This procedure takes into account all state and local services without references as to whether they are labor, cash, or capital intensive.

The best measure of financial responsibility is *total revenues own sources less liquor stores* (mostly state operated) *and utilities* (locally operated). This results in a comprehensive measure that covers nearly all revenue sources and eliminates erratic effects that derive from including liquor stores and utilities. Liquor stores are excluded because in states like New Hampshire inclusion would give the state government a disproportionate share of the state area allocation and we cannot find national policies for the promotion of state or local ownership of liquor dispensing facilities. There is a similar lack of national policy relating to public ownership of utility services, with the possible exception of water and transit, but these are minor items in terms of per capita revenues. Over three-fourths of all utility services are privately owned and the incidence of public ownership is very different from one state to another and within the fifty states. Why should local governments in Nebraska get a disproportionate share of GRS funds because they have mostly locally owned utilities? Nearly everyone pays for their own utility services whether it is publicly or privately provided. In contrast to general revenues, insurance trusts are included in this measure for several reasons. One is to make the state/local revenue systems comparable in terms of cash, capital, and labor intensity of typical state and local services. Another is that other kinds of cash intensive services are included in general revenues so why should this item be excluded? This measure includes 94 per cent of total revenue own sources and all general revenues own sourcs. The abbreviation for this measure is FIN.

The best analytical measure of service delivery is called the *revised service delivery index*, but it requires considerable data manipulation and can only be updated once every five years with the publication of data from the Census of Governments. It measures service delivery systems for 23 state and local functions as to whether they are locally, jointly, or state operated and weights each service according to its national importance as indexed by per capita expenditures. Each index is closely associated with the per capita spending pattern in each state, but it also measures which level delivers the service package. The 23 services utilized in the revised service delivery index (SER) account for 98.4 per cent of all state and local general expenditures and 93 per cent of total spending. In the Report, SER is used primarily for analytical purposes and to judge proxy measures of service delivery.

The best operational measure of service delivery is *total direct expenditures less liquor stores and utilities* (EXP). The same reasoning applies to the exclusion of liquor stores and utilities and the inclusion of insurance trusts as for the above measure of financial responsibility. EXP includes all direct general expenditures and 94 per cent of total direct state and local expenditures. It is a very good proxy measure for service delivery (r=+.90).

Our recommendations relative to the division of GRS monies between state and local governments use measures that combine financial responsibility with responsibility for the actual delivery of public services recognizing that both are important aspects of the state/local systems. The best analytical measure combines financial responsibility (FIN) with the revised service delivery index (SER) and is designated *combined index no. 1* (COM #1). The best operational index is *combined index no. 2* (COM #2) utilizing each state's average for FIN and EXP. This is much simpler to calculate and can be updated annually. The operational index, COM #2, is an excellent proxy measure for the analytical index, COM #1, with a correlation of +.96 and a coefficient of determination of .93.

While these are considered the best measures of relative state and local performance, every measure utilizing revenues, expenditures, or both does a better job of adjusting the state/local split than present GRS legislation.

STATE/LOCAL PERFORMANCE

The current state/local split of GRS monies does not relate to the performance of state and local governments either on the average or with reference to the range of differences among the fifty states. The present division is wrong in terms of common equity and placing the money where the action is, regardless of the performance measure used. It comes closest to the situation in our two mega-states, New York and California, but even here there are differences. There are wide variations among the states in state/local responsibility at the same time the average state delivers directly a bit more than half and pays for about three-fifths of the service package, with range from less than one-fourth to over four-fifths depending upon the index utilized. The major trend of the past sixty years is toward more state government responsibility in both the financing and delivery of public services. At the turn of the Century all states with one minor exception were highly decentralized. Today only two remain decentralized. Utilizing a composite measure of state centralization (personnel, financial responsibility and service delivery), six fall in between decentralized and balanced systems, twenty-three have balanced state/local systems, eleven are between balanced and centralized, and eight have centralized state/local arrangements. These tabulations are for 1972 as it is yet too early to obtain adequate data for more recent years. As a consequence, the one-third state/two-thirds local distribution of GRS funds is almost totally out of phase with state/local measures of performance.

As mentioned earlier, for the most part we use average state figures rather than national total data because our two mega-states, New York and California, distort the national totals for state responsibility downward making it appear that the state level is much less active than is the actual situation for the average state government. Direct expenditures (EXP) average 47 per cent state and 53 per cent local with a range from 26 per cent state in New York to 81 per cent in Hawaii. The service delivery index (SER) averages 52 per cent state/48 per cent local with a range from 32 for the state level in New York to 84 per cent for Hawaii. Financial responsibility (FIN) is more centralized with a state government average of nearly 60 per cent and differences ranging from the low of 44½ per cent for Nebraska to a high of 79 per cent state in Hawaii. The best combined index for analytical purposes (COM #1) places state government responsibility at 56 per cent on the average with a range of variation from 41 per cent, New York, to 82 per cent, Hawaii. The best operational combined index (COM #2) gives the average state 53 per cent responsibility with variation from 38 per cent New York to 80 per cent Hawaii. Similar differences were found in all of the dozen or so measures tested in this research. The numbers of states classified in different categories of state responsibility are as follows:

State proportion of service responsibility	Number of States				
	Expenditures	Services	Finances	Combination 2	Combination 1
60 percent or more	5	8	21	10	11
55 to 59.99 percent	3	8	11	11	12
45 to 54.99 percent	19	22	17	22	25
40 to 44.99 percent	11	8	1	6	2
39.99 percent or less	12	4		1	
Percent:					
Average State	47.0	51.7	59.6	53.4	55.7
Low State	26.2	32.2	44.5	38.0	41.1
High State	80.7	84.4	79.2	79.9	81.8

Combined index no. 2 is the one on which all of the recommendations in this report are based. COM #2 takes each state's average for total direct expenditures less utilities and liquor stores (EXP) as a measure of service delivery and total revenue own sources less utilities and liquor stores (FIN). Table No. 1 gives each state government's rating for each of these measures as a proportion of state and local responsibility and its rank among the fifty states.

The state/local mix of public services varies somewhat from state to state as does service emphasis. Nevertheless, there is a group of services that is universally or almost universally state level functions and another that is typically locally administered. Those typical state functions are social insurance and insurance trusts, higher education, special education, corrections, highway construction, natural resources, liquor stores, and public welfare. At a different level of conceptualization, subsidy of local government is also a state function. Locally administered services typically include general control, airports, housing and urban renewal, police, fire protection, elementary and secondary education, sewerage and other sanitation, parks and recreation, parking, and utilities. Each group, local and state, accounts for about two-fifths of state and local per capita spending.

TABLE 1.—THE STATE/LOCAL SPLIT OF SERVICE RESPONSIBILITY, 1972

State area	State code	Total less liquor stores, utilities, and parking: Revenue own sources (finances) State percent	Rank	Total less liquor stores, utilities, and parking: Direct expenditures State percent	Rank	Best operational index—combination 2 (finances plus expenditures) combined index No. 2: Percent State	Percent Local	Rank	Best research index—combination 1 (finances plus services) combined index No. 1: State percent	Rank	Revised service delivery index (services): State percent	Rank
Hawaii	12	79.2	01	80.7	01	79.9	20.1	01	81.8	01	84.4	01
West Virginia	49	74.2	04	64.6	03	69.9	30.1	02	69.3	04	64.4	05
Alaska	02	73.2	05	66.5	02	69.9	30.1	03	71.1	03	68.9	02
Kentucky	18	70.3	08	61.3	05	65.8	34.2	04	65.7	05	61.1	07.5
Delaware	03	75.3	03	54.3	09	64.8	35.2	05	71.6	02	67.8	03
New Mexico	32	76.7	02	51.7	16	64.2	35.8	06	65.5	06	54.4	17.5
Vermont	46	62.2	19	63.5	04	62.9	37.1	07	63.9	08	65.5	04
Utah	45	67.1	11	56.4	07	61.8	38.2	08	63.0	10	58.9	09
Rhode Island	40	65.4	13	57.6	06	61.5	38.5	09	64.3	07	63.3	06
South Carolina	41	70.6	07	50.7	19	60.7	39.3	10	63.7	09	56.7	13.5
Louisiana	19	68.2	09	50.6	20	59.4	40.6	11	61.3	11	54.4	17.5
Arkansas	04	65.8	12	52.8	12	59.3	40.7	12	59.5	13	53.3	20
Oklahoma	37	63.9	15	53.4	10	58.6	41.4	13	58.6	16	53.3	20
Alabama	01	64.9	14	15.6	17.5	58.3	41.7	14	57.5	20	50.0	28
Mississippi	25	67.3	10	49.4	21	58.3	41.7	15	58.7	15	50.0	28
Maine	20	59.9	22	55.6	08	57.8	42.2	16	58.3	17	56.7	13.5
Idaho	13	62.8	17	52.5	13	57.7	42.4	17	55.3	22	47.8	34.5
North Dakota	35	62.9	16	52.2	14	57.5	42.5	18	59.8	12	56.7	13.5
North Carolina	34	70.9	06	42.1	30	56.5	43.5	19	57.6	19	44.4	39.5
Washington	48	62.5	18	48.3	23	55.4	44.6	20	52.9	30	43.3	42.5
Wyoming	51	58.6	25	52.0	15	55.3	44.7	21	54.8	24	51.1	24
Pennsylvania	39	61.8	20	47.7	26	54.8	45.3	22	59.2	14	56.7	13.5
Montana	27	53.8	37	53.3	11	53.6	46.4	23	55.3	23	56.7	13.5

Connecticut	07	54.6	33	47.9	25	51.3	48.7	24	57.9	18	61.1	07.5
Arizona	03	61.2	21	40.4	38	50.8	49.2	25	55.6	21	50.0	28
South Dakota	42	49.6	47	51.6	17.5	50.6	49.4	26	53.2	29	56.7	13.5
Georgia	11	57.1	28	43.7	28	50.4	49.6	27	51.4	35	45.6	38
Virginia	47	59.8	23	41.1	32	50.4	49.6	28	53.8	27	47.8	34.5
Tennessee	43	57.9	26	42.8	29	50.3	49.7	29	53.9	26	50.0	28
Oregon	38	54.2	36	46.0	27	50.1	49.9	30	52.1	32	50.0	28
Massachusetts	22	50.4	43	48.0	24	49.2	50.8	31	51.3	36	52.2	22.5
Nevada	29	56.7	29	41.0	33	48.9	51.1	32	53.4	28	50.0	28
New Hampshire	30	47.7	49	49.3	22	48.5	51.5	33	52.8	31	57.8	10
Michigan	23	56.4	30	39.5	40	47.9	52.1	34	49.9	41	43.3	42.5
Colorado	06	54.3	34	40.9	34	47.6	52.4	35	47.2	43	40.0	46
Texas	44	54.2	35	40.5	35	47.4	52.6	36	51.6	34	48.9	32
Wisconsin	50	58.8	24	35.6	47	47.2	52.8	37	46.6	45	34.4	48.5
Ohio	36	53.0	38	40.4	37	46.7	53.3	38	50.4	37	47.8	34.5
Illinois	14	51.6	40	41.5	31	46.6	53.4	39	51.9	33	52.2	22.5
Maryland	21	56.3	31	37.0	42	46.6	53.4	40	54.8	25	53.3	20
Florida	10	55.6	32	35.8	46	45.7	54.3	41	50.0	40	44.4	39.5
Iowa	16	52.2	39	39.2	41	45.7	54.3	42	50.0	39	47.8	34.5
Missouri	26	50.6	42	39.9	39	45.3	54.7	43	50.3	38	50.0	28
Minnesota	24	57.4	27	31.6	49	44.5	55.5	44	48.1	42	38.9	47
Indiana	15	50.2	45	36.9	43	43.6	56.4	45	46.8	44	43.3	42.5
Kansas	17	50.8	41	36.1	45	43.5	56.5	46	46.0	46	41.1	45
Nebraska	28	44.5	50	40.4	36	42.5	57.5	47	45.6	48	46.7	37
New Jersey	31	48.0	48	33.3	48	42.3	57.7	48	45.7	47	43.3	42.5
California	05	50.4	44	36.5	44	41.8	58.2	49	42.4	49	34.4	48.5
New York	33	49.8	46	26.2	50	38.0	62.0	50	41.1	50	32.2	50
Average State		59.6		47.0		53.4	46.6		55.7		51.7	

The other twenty percent of per capita expenditures comprise a group of activities that may either be local or state administered or jointly performed. Health and hospitals are either state or jointly administered. Financial administration and highway maintenance are functions usually carried out by both levels. Water transport is either state or local, seldom jointly administered. Financing debt, public buildings, and other and unallocable are usually joint or local activities. General government tasks are mostly a function of the number of local governments that exist in a state. Overall, the pattern of service distribution is not arranged one-third state/two-thirds local.

State/Local Systems, GRS, and Other Factors

Over three-fourths of the variation among the states in state/local service responsibility (state centralization) is explained by population size, the state/local tax structure, and the state system of local government. Centralized states have smaller population, the bulk of the taxes at the state level, and more centralized systems of local government. The reverse is true for decentralized states. The state/local split of GRS funds bears no significant relationship to any of these variables as it now operates.

Large states populationwise tend to be decentralized, small states centralized, and this is a relationship that carries through all of the analyses. The large state/small state syndrome may indicate that there are economies and diseconomies-of-scale operating in the delivery of state and local public services. If this is the case, small states find it economically advantageous to provide many services directly while in large states it is feasible to delegate service delivery to local governments, at least to the largest of their local units. Interfering with this by the application of an arbitrary one-third state/two-thirds local split of GRS monies could lead to uneconomic service delivery arrangements.

RECOMMENDATIONS

Recommendations for changing the General Revenue Sharing formula with reference to the state/local division of monies come in several orders of magnitude depending upon what is politically feasible: 1) the most desirable and comprehensive change, 2) those for a direct adjustment of the state/local split, 3) keeping the one-third/two-thirds national division with variation according to state service responsibility, and 4) other needed adjustments in present legislation.

In the interest of maintaining a federal system and meeting the needs of very different state/local systems, General Revenue Sharing must be tailored to the range of variation that exists and allocate funds according to where the action is, i.e., state and local responsibility for public services.

The most desirable and comprehensive change would be to give the state government the entire state area allocation and let it distribute these funds to state and local governments as appropriate to meet national guidelines. Such a procedure is most compatible with the federal arrangement and the systems approach to state and local government. This could be done with or without pass-through requirements, but with pass-through requirements it should be tailored to the state/local system in each state. Moreover, it allows the state to apply the money where needed at either the state or local level. It eliminates the need to define what a "general purpose" local government is (a very difficult exercise) and largely eliminates the duties of the Office of Revenue Sharing. This would place responsibility upon the state government for solving service delivery problems and those associated with the state/local system of government, urban or other. It would also transfer political hassles over state/local and interlocal allocations from the national government to the state level where they belong.

If the above suggestion is not politically feasible in the current climate of opinion, it is still necessary to adjust the state/local split in a manner which reflects state and local responsibility. These divisions should be keyed directly to the differences in state/local financial and service responsibility in the interest of attaining an equitable arrangement appropriate to the performance levels for the individual states. An abrupt change from an arbitrary to a performance division of the funds would cause discontinuities in payout to individual governments. It would most drastically affect the state level in decentralized systems and local governments in centralized states. ***Therefore, a five-year phasing-in the degree possible.*** Such a procedure means over four-fifths of the recipients would either be held harmless or experience per capita increases.

If maintenance of the present state/local division should become of overriding political importance, two alternative algorithms are suggested. Both make adjustments for states that deviate from 33.33 per cent, but not in direct proportion to the differences. The first gives the state government one-half of the difference between its actual responsibility and 33.33 per cent. Said procedure, using combined index no. 2 (COM #2), the criterion for all recommendations, results in a national split of 40 per cent state/60 per cent local. The second algorithm simply weights local responsibility as twice as important as state in the computation of service responsibility. This results in a national distribution of one-third/two-thirds with state variation up and down from that figure. The algorithms should be used as a very last resort. The logic of weighting a service as twice as important if locally provided than if state administered is quite difficult to comprehend.

Whatever the procedure used to accommodate state/local variation, it should be updated annually and phased-in over a period of time holding harmless as many recipients as possible. Without annual update of the data, discontinuities result when the data are updated. If GRS funds are increased at a rate of four per cent per year or better, the phasing-in process means the overwhelming majority of recipients are held harmless.

Within the context of the report a number of other adjustments in GRS legislation are suggested. The present definition of a general purpose local government is inadequate due to wide interstate and intrastate variations in what is called a municipality, county, town or township government. GRS is a poor vehicle for aiding native Americans. They should be separately provided for. The amounts various groups receive is not related to need. It is whipsawed back and forth by interstate and intrastate allocation formulas. *The maintenance-of-effort provision is ineffective as it now stands due to the effects of inflation.* If allocations are to be an arbitrary ratio, it is questionable as to whether or not there should be such a provision. *The section of the law dealing with state assumption of new activities is ineffective.* There are unexpected costs to the states in trying to do this and some say a lack of cooperation on the part of the Office of Revenue Sharing. *Consideration should be given to using revenue effort instead of tax effort for the interstate and intrastate allocations.* In some ways the use of tax effort penalizes those states and localities that have developed a broader revenue base.

POLICY ISSUES

One of the issues in the past has been state budget surpluses, but this surplus is largely illusory. Much of the surplus that appears at both the state and local levels is as yet unexpended GRS monies—and there is a necessary time lag. Both levels have unmet needs. Some of the surplus is due to the fact that more states are now funding retirement systems and they did not always do so in the past. If the actual budget surplus of 1972 had been distributed to local government, it would have meant only a one per cent increase in state aids. Looking at the end of the current budget year and the beginning of the next, state governments are not in a very good financial position. Recent estimates show that 13 states will end the year with a small surplus of revenue over expenditures, but some of these will evaporate by the time the final figures are in. About twenty states are spending past surplus accumulations at the same time part of these are curtailing services. Eight states will either have to raise taxes or cut back services. Nine are in a deficit financing position. For 1976 state spending will go up in current dollars, but if we add up surpluses, deficits, and service cutbacks, including the havoc caused by inflation, the states will have a real deficit of $10 billion or more. Similar situations exist for many local governments. Neither level has a corner on financial crisis.

At the same time most state and local governments have more tax and revenue authority than they are willing to use. The overwhelming majority in this sense are sound financially. Most local governments would rather obtain federal and state aid than use the sources already available to them or ask for new sources. A few have reached the limit, but these are the exceptions. The property tax is an inequitable and inefficient source of local income, but it is not the only source and by the next year local governments will be receiving more in state and federal aids. The local units for which this is the only source are usually rather minor political subdivisions. Local resources are badly distributed, but redistribution among localities is a state function and can really only be solved at that level.

The so-called "urban problem" cannot ultimately be solved by throwing Federal money at it. For some things money can help, but it will not solve the problems of local or state governments unless other actions are taken. The urban problem is a national issue because we are an urban nation, but in a very real sense it is a problem for state/local systems as they are the ones that will ultimately have to deal with state/local governmental arrangements, finances, and service delivery. Simply throwing Federal money at them may mitigate the need for the states and their subdivisions to deal with these problems. Free money tends to support existing governmental arrangements even though some are inadequate, outdated, and atrophied.

General Revenue Sharing is a general program of financial support to state and local governments. It cannot and will not solve all of our governmental problems and be all things to all governments. Even if all of these funds were to go to cities, they would not solve our urban problems or even our urban financial problems. Nevertheless GRS can be more effective by gearing its distributions to the system and performance of state and local governments.

POLITICAL FEASIBILITY

The political feasibility of adjusting the state/local split to performance or to the system depends in part upon the number and type of political issues included in the decision matrix.

If we assume that political influence in Washington is directly proportional to the number of local and state governments lining up at the U.S. Treasury, then we can conclude that very shortly all Federal aids will be going directly to local governments and the states will get nothing—there are nearly 800 times as many local recipients under GRS. But large units seem to have more influence than small ones. Those with organized lobbyists have more access than those that are unorganized. On the other hand, the situation is reversed somewhat when we consider the role of local governments vis a vis the states in a two-tier federal system. The delineation of raw political power lies somewhere in between these two models and a number of other issues must be considered. There is the need for equity and the issue of adapting Federal policies to the state/local system, unless the national government is out to change that system. If the Federal government is out to change the system, this should be an open policy question, not one hidden in a formula. There are also questions as to whether some of the organized interests can deliver when it comes to the 1976 election and even whether GRS will be an important political issue at that time. In all probability, GRS will not be an issue on which the 1976 elections will be decided. There is also the problem of short-range political advantage versus long-term political consequences. In the short-run it may be advantageous to count heads while over a longer time-span the disadvantages of disrupting the operation of state/local systems could far outweigh immediate gains. The one-third/two-thirds split might have been appropriate in the 1920s and earlier; it is almost entirely inappropriate today. Continuation of the present state/local split over a long time period could result in less, not more, state-local cooperation in the financing and delivery of public services.

If discretionary use of money is power, and it apparently is in the American system (though not the only source), then by undertaking state/local and interlocal distributions of GRS funds the Federal government is redistributing power so long as the allocations do not reflect the operation and performance of state/local systems. Should the power to distribute be given to the state level, then it would depend on the operation of the state/local political system to determine how much money is passed-through to local units and the distribution among local units could be much more closely related to performance. This in turn depends upon how well the state/local systems function. Local governments could be quite upset by this kind of alteration in GRS. They would have to compete in their own political arena, one where the state and other local units are much more cognizant of levels of performance. An immediate shift from the present arbitrary split to one based on performance would lower per capita receipts for most local governments. If, on the other hand, we assume a gradual increase in GRS funding (about 4 per cent a year) and a phasing-in of the change, the overwhelming majority of local governments will experience increases or be held harmless during the next five year period. A great deal depends upon how the change is made.

Political feasibility extends beyond a mere counting of the numbers of governments involved to issues of equity, performance, systems of state/local government, roles of various levels in a federal system, and the long-term effects of present and projected allocation arrangements. Failure to adapt GRS to the realities of state and local systems—legal, financial, service, and political—is indicative of a structure unable to rectify past inadequacies and accommodate change.

CONCLUDING REMARKS

The concept that state and local governments are not distinctly separate levels of government but parts of a complex interacting and interdependent state-local system leads to the conclusion that national "treatment" in the form of Federal aids should be focused toward the systemic nature of the problems and not at the symptoms. For GRS this would mean giving the money to the state governments for distribution or, at the very least, distributiing the monies to the governments responsible for financing and delivering public services.

It is not possible from this research to conclude that GRS does a good job of dividing the funds among local recipients. Yet, the interlocal allocations are much more attuned to the interlocal division of service responsibility than is the state/local split. The reason for this is it utilizes proxy measures of need, resources, and service population. The interlocal allocation is better only because some attempt is made to measure these things, not because these indices are a direct reflection of the real social, economic, and service problems of local governments.

As stated earlier, GRS cannot solve all of our governmental problems; it is for the general financial support of state and local governments. A number of these problems are being dealt with in part through such measures as LEAA, the Community Development Act, categorical grants, and other Federal legislation. And states have not been inactive in their support of local government, urban or other. Some problems can be solved or mitigated by throwing money at them. Not all problems are soluble. Many of the difficulties of a place like New York City are ones that require concerted effort on the part of both the city and the state. There are those that are self-generated, as well. It is just possible that some Federal aids may temporarily alleviate the need for local and state officials to seek local and state solutions to their difficulties. If we retain a federal system, the long-term solutions to the urban crisis, service difficulties, and financial problems of both levels are going to have to come from the state/local system, not from the national treasury. Interstate redistribution of resources is clearly a national function, but it is much more difficult to justify a national role relative to the reallocation of resources within the states.

Chairman BOLLING. Thank you very much.

Mr. Morton Lustig from the University of Pennsylvania.

STATEMENT OF MORTON LUSTIG, PROFESSOR, SCHOOL OF PUBLIC AND URBAN POLICY, UNIVERSITY OF PENNSYLVANIA

Mr. LUSTIG. Our problem was that of fluctuations, or the change in the amount of allocation received by an individual government in two successive entitlement periods.

We wanted to look at least at two pairs of periods, so we doubled the allocations of entitlement period 3—a 6-month period—to get the equivalent of 1 year allocations. We then examined changes from entitlement periods 3 to 4 and 4 to 5. We found that only about 50 percent of all governments change by 10 percent or less from one period to the next; some go as low as minus 100 percent, and a very few go as high as 1,000 percent increase. Extreme fluctuations occur in relatively small numbers, but it is clear that important changes do exist.

The second question, given the existence of fluctuations, asks to what extent they make problems for local governments in fiscal planning and budgeting.

We sent questionnaires to about a thousand governments—and here's the clinker, they are so sick of revenue-sharing questionnaires, that one asked for $25 to fill out the questionnaire. [Laughter.]

And one small community sent me their ledgers and said, "You fill it out and send the books back." [Laughter.]

Nevertheless, we got about 100 good returns from which we made observations about the size of revenue sharing in relation to total expenditures of communities, which are moderate in most cases.

But because we also talked to local government officials in four States—Pennsylvania, California, Minnesota, and Mississippi—we discovered that even small fluctuations can be embarrassingly large in relation to the change in the total budget. We had a case, for example, of a large city which lost four times as much money from their allocation from one year to the next as the decrease in their total budget. They had to raise taxes in order to decrease their expenditures.

Discussions with public officials, mostly local government officials, also showed some concern over fluctuations generally, although less positively expressed than in the questionnaires. Concern also seemed to vary a good deal in relation to the degree of control by local governments over their taxes and spending. The tighter the constraints on local officials, the more worried they were about uncertainty in revenue-sharing funds.

In Mississippi, where tax limitations are the most severe, and where local officials have the least leeway in what they do and how they finance what they do, almost everybody that talked to us—from large cities, small cities, counties of various size—jut revenue-sharing money into capital expenditures. And they did that mostly because they were worried that discontinuation of the program or large allocation changes from year to year would get them in trouble if they undertook operating programs.

It also is the case, however, that putting money into capital reserves when the community knows what capital projects are intended—build a jail, replace a school that burned down, expand a hospital—and knows the timetable as well, creates risks for local officials who fail to perform in accordance with timetable.

Serious cuts in allocations could therefore be difficult for people who are using the money for capital purposes, and we always thought they were evading the tensions of uncertainty, in revenue sharing.

Now, we experimented with four ways to restrain fluctuations, one of these was to allow no fluctuations, more than 10 percent in either direction, up or down, and obviously that slices fluctuation right to the bone. In the process of limiting fluctuations we changed the allocations significantly, but it doesn't seem to benefit one type of government over any other type of government; if anything, townships come out a little lower and counties and cities a little higher.

Then we tried minimizing fluctuation on the downward side only by limiting drops of fluctuations to minus 10 percent on the notion that people don't worry too much about upward fluctuations, they only worry about downward changes. This constraint also has the effect of reducing fluctuations substantially. With respect to allocations, townships make out a little better and counties not quite so well as with the first constraint.

Third, we though we might minimize downward fluctuations only for needy governments. We reasoned that needy governments are most worthy of protection from large cuts in funding. In order to use the terms of the formula, we defined need as the per capita income of each community relative to the per capita income of its State. This constraint does reduce fluctuation, but not in a very well organized way.

The last method tried was "smoothing" or moving averages. Since fluctuations occurred from period to period, we added data for two periods together and divided by two in order to get data to be used for computing the second period allocation. For example, we added adjusted taxes of a government for periods 3 and 4, divided by two, and used that average for the taxes of period 4 in computing allocations. Taxes of periods 4 and 5 were added, divided by two, and the average used as the taxes of period 5.

That technique also has the effect of reducing fluctuation by increasing the total number of communities within the plus or minus 10-percent fluctuation range. When you get outside the 10-percent range in the periods 4–5, smoothing inflates the positive fluctuations a bit.

In applying these constraints, we overrode the 20-percent, 145- and 50-percent statutory restrictions on the grounds that we wanted to know the full effect of fluctuation constraints. We did, however, identify the number and types of violations which occurred. We found that the "smoothing" technique produces no violations; the other three do. Counties have no violations, but cities and townships do; and in some cases the number of violations are relatively high. Pennsylvania townships, for example, are heavy violators on the minus 10-percent fluctuation constraint. In most cases, townships fall under the 20-percent floor, rather than going over the 145-percent ceiling.

Under the strictest definition of our objective, which was to identify the constraint that most reduced fluctuation, the best system is that which provides the smallest mean and standard deviation of fluctuations. The plus or minus 10-percent constraint clearly met that criterion.

A secondary criterion for a good constraint was one that best met the preferences of most government officials. Based on both questionnaires and interviews, the minus 10-percent constraint met that requirement. Unfortunately, we think some wild Indian fluctuations, or wild fluctuations of Indians, if you prefer, got into the calculations on minus 10 percent; and in periods 3–4 we have very high means and standard deviations. In periods 4–5, that constraint had rather good means and standard deviations.

[The prepared statement of Mr. Lustig follows:]

Prepared Statement of Morton Lustig

Analysis of Fluctuations

Fluctuations are measured by changes in revenue sharing allocations for individual units of government between consecutive entitlement periods. All types of government receiving revenue sharing funds have a wide range of fluctuations.[1]

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[1] Total funds available for revenue sharing increase by about 2.5% per year; given the wide range of fluctuations, we have not corrected fluctuations figures for this built-in change.

FLUCTUATION BY TYPE OF GOVERNMENT ENTITLEMENT PERIODS 3–4[1] AND 4–5

	Percentage of governments									
	States		Counties		Places		Townships		Tribes	
Percent fluctuation	3–4	4–5	3–4	4–5	3–4	4–5	3–4	4–5	3–4	4–
−100 to −75				0.1	.9	0.8	0.8	0.5	1.8	
−75 to −50			0.3	.3	2.9	1.3	3.8	1.4	1.4	
−50 to −25			3.7	3.1	8.5	5.8	10.4	7.2	4.2	0.2
−25 to −10		2.0	15.7	14.5	14.7	12.2	13.9	14.9	12.1	6.8
−10 to −5		5.9	13.3	13.9	9.1	9.2	7.3	8.8	9.9	13.7
−5 to 0		15.7	16.9	17.9	10.2	13.7	8.9	11.1	16.5	15.9
0 to 5	100	62.7	16.4	17.8	21.1	21.3	29.0	31.6	33.4	32.4
5 to 10		11.8	9.9	12.7	6.2	9.9	4.5	5.7	5.8	13.1
10 to 25		2.0	14.2	13.8	10.9	13.8	8.4	9.7	9.1	13.5
25 to 50			6.3	4.5	7.5	6.7	5.9	5.0	4.4	1.4
50 to 75			1.9	.9	3.1	2.3	2.8	1.8		2.2
75 to 10			.7	.2	1.6	.9	1.5	.9		.2
100 to 200			.4	.2	2.2	1.4	2.0	1.1		.6
more than 200			.2		1.1	.9	1.0	.4	1.4	

[1] EP 3 was a 6-mo period; allocation total was doubled and distributed to obtain a full year equivalent.

It is not surprising that state governments cluster near zero change between years; the data elements for state governments did not change in periods 3–4. The other forms of government, including tribes, concentrate much less than states near the zero change mark.

The table above suggests another pervasive set of changes below the state level. All governments (and tribes) have a more concentrated distribution of fluctuations in entitlement period 4–5 than in 3–4. The positive and negative tails get smaller, a higher percentage of governments fall in the range of plus 25% change to −25% change.

Compression of data for individual states, individual counties, and other forms of government into *nationwide* totals or averages is useful but not sufficient. In order to compare the distribution of revenue sharing fluctuations for individual states we have used the simplified measure of changes within plus or minus 10% to represent relatively stable allocations. As a base for comparison, the percentage of units within ± 10% for all governments is:

[In percent]

	EP 3–4	EP 4–5
States	100	96
Counties	56	62
Places	47	54
Townships	50	57
Tribes	65	75

PERCENTAGE OF LOCAL GOVERNMENTS FLUCTUATING BY ± 10 PERCENT, ENTITLEMENT PERIODS 3 TO 4 AND 4 TO 5 BY NUMBER OF STATES

	Number ot States by—							
	Counties		Places		Townships		Tribes	
Percent governments with ±10 percent fluctuation	3 to 4	4 to 5	3 to 4	4 to 5	3 to 4	4 to 5	3 to 4	4 to 5
Under 20 percent	1	2		1		1		3
20 to 39 percent	8	3	11	4	2	2	3	
40 to 59 percent	19	14	29	30	15	10	2	4
60 to 79 percent	18	22	8	13	2	6	8	8
80 to 100 percent	3	8	2	2			17	15
Total	49	[1] 49	50	50	19	19	30	30

[1] Connecticut has no counties.

Application of the same measure of relatively stable units to the states shows wide variation among them. A small handful of states has at least some local government types with less than 20% of their members within the 10% limits, and a slightly larger handful has types of government with 80% or more of their members within the 10% limits.

Interviews and Surveys on Governmental Reactions to Uncertainty

Measurement of the frequency, scale, and incidence of fluctuations does not demonstrate the need for correction. Fluctuations need correction only if they produce inequities in distribution or marked uncertainty in the officials who incorporate revenue sharing allocations into operating and capital budgets. Two research techniques were adopted to examine attitudes: the first was a questionnaire mailed to almost 1,000 units of government, including all 50 states and a stratified random sample of counties, places and townships sorted by population size. The second required interviewing officials of local government and leagues of municipalities in four states: Pennsylvania, California, Mississippi and Minnesota. The states were chosen to represent geographical diversity, varieties in per capita income levels, degrees of urbanization and differences in the strength of local governmental units.

Interviews suggest that for most governments fluctuations hurt; they contributed to the uncertainty over the program's life (accentuated by the recent cancellation of other federal grant programs). Uncertainty reinforces conservatism in the use of funds which may itself inhibit the possibility that the original intention of Congress would be fully satisfied as to the uses of the grants.

Questionnaire returns proved a poor sample. Apparently, in the wave of enthusiasm to study revenue sharing, local officials have been deluged with questionnaires. Our returns are fewer than expected and many questionnaires are only partially filled out. Thus we present the returns as suggestive only, although we have more confidence in our conclusions than the numbers may warrant because our interviews and the results of other studies at least indirectly reinforce our findings (see tale below).

If one looks at the good, fair, poor choices in the table, part *a* (limit up and down changes by 10%), and part *b* (limit down changes only by 10%) are close competitors for first place. Part *b* has more "goods" than *a*, but *a* has fewer "poors" and more "fairs" than *b*. The worst showing is made by *d* (limit change to some percent of tax revenue) with the fewest "goods" and the most "poors" followed by *e* (limit changes for needy governments only). Part *c* (no changes, the status quo) is rather well belanced on "good" and "poor."

The rankings present a somewhat different view of preferences than the choice questions. Part *a* (up and down) and part *b* (down only) again seem to be almost equal in terms of first, second, and third places, versus fourth and fifth places. Part *c* (status quo) is a bit of a surprise with the highest number of first places—and the second highest in last places. Part *e* (limit for needy governments) has a mixed pattern with heaviest weights at the bottom; the rankings imply a little less positive feeling about constraints than the choices did.

Question 18.—In the real world complete guarantees of fixed revenue sharing funds are impossible but there are a number of ways to limit the amount of year to year change in revenue sharing payments to your government; evaluate each of the following as good, fair or poor and then rank them in order of your preference.

Change and choice	Total	Rank	Total
a. Limit upward and downward changes from yr to the next by a fixed percentage limit, say 10 percent:			
Good	39	1	19
Fair	39	2	24
Poor	15	3	20
	----------	4	13
	----------	5	5
b. Limit only downward changes from 1 yr to the next by a fixed percentage say 10 percent:			
Good	42	1	23
Fair	21	2	18
Poor	22	3	15
	----------	4	14
	----------	5	5
c. No limits at all, leave it as is:			
Good	30	1	24
Fair	31	2	12
Poor	27	3	17
	----------	4	10
	----------	5	19
d. Limit the change to some percent say 5 percent of total tax revenue of the previous year (NB this refers to total tax revenue):			
Good	16	1	10
Fair	28	2	11
Poor	38	3	17
	----------	4	23
	----------	5	16
e. Limit downward changes for needy governments only. Those with high taxes and modest resources per capita; those for which revenue sharing makes up a large percent of total revenue:			
Good	22	1	11
Fair	25	2	14
Poor	35	3	12
	----------	4	13
	----------	5	28

Note: Some respondents marked only some choices or some ranks, and a few marked tie votes.

Constraints To Reduce Fluctuations

Four constraints were considered in only four states, California, Minnesota, Mississippi, and Pennsylvania, for economy of effort. The states provide good test material because of their variety in governmental structure, income level, and division of governmental responsibilities among states, county, and local jurisdictions.

The constraints considered were:

1. Fluctuations limited to plus or minus 10%;
2. Downward fluctuations limited to minus 10%;
3. Downward fluctuations limited to minus 10% for needy governments only;
4. Smoothing all data elements by using a two year moving average.

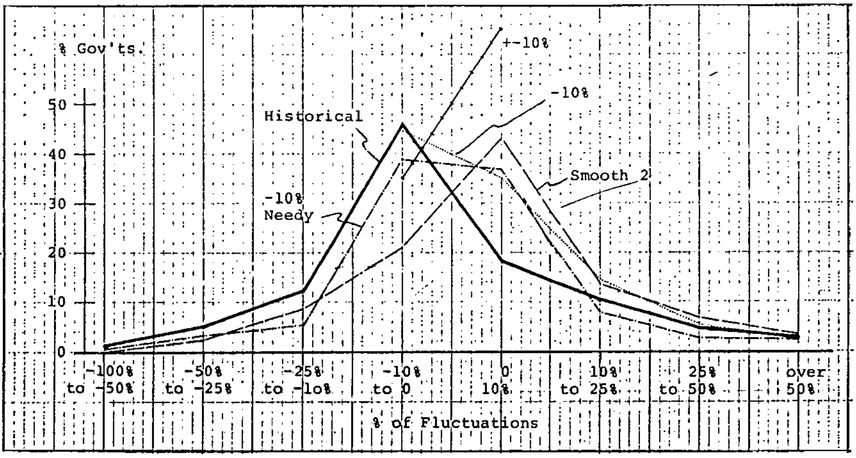
Results are summarized in the following table and graph. All constrained fluctuations in EP 3–4 are more concentrated than the historical fluctuations; all have higher percentages of governments concentrated within fluctuations of −10% to +10%, and all have smaller percentages in the tails (smaller than −10% and larger than +10%). The first constraint (±10% has all governments in the mid range, of course, and no tails. The second constraint (−10%) has three-quarters of the fluctuations within −10% to +10%) compared with one-half for historical fluctuations), no tail on the minus side, and slightly smaller proportions in the tail above +10% fluctuations than are found in the historical distribution. The third constraint (limiting fluctuations to −10% for needy governments) has about two-thirds of its governments in the middle range of fluctuations and both tails well below the historical percentages. The last constraint (smoothing) is much like the third with a little more concentration from −10% to +10% and the lowest percentages of government fluctuating by 25% or more and −25%, or less. In EP 4–5 relationships are about the same, although the historical distribution is more concentrated than it was in EP 3–4.

FLUCTUATIONS FOR ALL GOVERNMENTS, 4 STATE SAMPLE, HISTORICAL, AND STABILITY CONSTRAINTS

[In percentage of distribution]

Fluctuation	Historical	Stability constraints ±10	−10	−10 needy	Smooth 2 EP's
EP 3–4:					
−100 to −50	2.2			1.7	0.2
−50 to −25	7.4			5.9	3.8
−25 to −10	9.3			7.0	9.4
−10 to −5	6.7	32.6	33.4	25.3	8.8
−5 to 0	11.3	11.1	10.5	11.2	19.2
0 to 5	11.4	24.9	24.8	25.1	34.4
5 to 10	22.1	31.5	6.0	6.7	8.3
10 to 25	12.8		9.8	6.4	8.9
25 to 50	7.9		7.2	5.0	4.5
Over 50	9.0		8.2	5.7	2.6
Total	100.0	100.0	100.0	100.0	100.0
EP 4–5:					
−100 to −50	.8			.8	.6
−50 to −25	5.1			3.7	3.5
−25 to −10	12.2			5.5	8.6
−10 to −5	10.9	23.1	31.4	27.8	6.9
−5 to −0	34.7	11.8	13.2	11.6	13.6
−0 to −5	10.8	24.5	27.0	27.9	33.3
−5 to −10	7.3	40.6	8.7	8.8	9.9
−10 to −25	10.6		12.6	8.1	14.3
−25 to −50	4.5		4.9	3.3	6.4
Over 50	3.1		2.1	2.5	3.0
Total	100.0	100.0	100.0	100.0	100.0

Fluctuations of all governments by stability constraints for four States, Entitlement periods 4–5



The effect of constraints on large jurisdictions is presented in the form of per capita allocations for EP 5. The county per capita is added to the city per capita on the assumption that residents of the city benefit equally with other county residents in allocations to the county.[2]

[2] In other states the city does not benefit equally; a rough measure of the differential benefit is the difference in the county tax rate applied to the city and the rest of the county.

EP 5 PER CAPITA ALLOCATIONS TO LARGE CITIES AND THE COUNTIES IN WHICH THEY ARE LOCATED, WITH AND WITHOUT CONSTRAINTS

	Historical	Constraints: ±10 percent	Constraints: −10 percent	Constraints: −10 percent needy	Constraints: Smoothing
Los Angeles—city	$13.20	$13.22	$13.21	$13.34	$12.91
City plus county	26.05	26.09	26.06	26.32	26.26
San Francisto—city [1]	25.75	25.79	25.78	26.04	26.41
Minneapolis—city	14.67	15.16	14.23	14.59	14.92
City plus county	22.74	23.32	22.06	22.57	22.90
St. Paul—city	16.42	16.43	15.92	16.23	16.88
City plus county	24.48	23.62	23.74	24.21	24.40
Jackson—city	25.83	25.32	24.94	25.37	26.37
City plus county	33.40	32.74	32.20	32.75	34.07
Meridian—city	17.16	16.82	16.44	16.72	17.39
City plus county	27.94	27.37	26.75	27.21	28.42
Philadelphia—city [1]	26.76	26.76	26.76	26.76	26.76
Pittsburgh—city	26.76	26.76	26.76	26.76	26.76
City plus county	34.79	34.87	34.91	35.15	34.97

[1] City and county are coterminous; allocation is made only to city.

VIOLATION OF BASIC FORMULA LIMITS

It was stated earlier that constraints applied to reduce fluctuations ignored the basic formula limits on maximums and minimums for individual allocations. It is essential, however, to understand the extent of these violations so that public officials can make a policy decision on holding those limits or allowing violations in order to achieve reduced fluctuations.

VIOLATION OF FORMULA LIMITS BY STATE, BY TYPE OF GOVERNMENT, AND BY CONSTRAINT

Constraints to reduce fluctuation	California Places: Number	California Places: Percent	Minnesota Places: Number	Minnesota Places: Percent	Minnesota Townships: Number	Minnesota Townships: Percent	Mississippi Places: Number	Mississippi Places: Percent	Pennsylvania Places: Number	Pennsylvania Places: Percent	Pennsylvania Townships: Number	Pennsylvania Townships: Percent
EP 4:												
Constraint plus or minus 10 percent	0	------	32	4	114	7	48	17	36	4	45	3
Constraint minus 10 percent	0	------	28	3	88	5	40	14	31	3	27	2
Constraint minus 10 percent needy	9	2	12	1	60	3	6	2	31	3	114	7
EP 5:												
Constraint plus or minus 10 percent	2	1	24	3	103	6	22	8	20	2	36	2
Constraint minus 10 percent	8	2	50	6	147	8	27	9	42	4	27	3
Constraint minus 10 percent needy	13	3	21	3	21	1	3	1	79	5	163	11

Note: Percent based on the total number of places or townships of each State. Smoothing forces no violations; counties have no violations.

A FORMAL TEST AND CONCLUSION

The project proposal defines the lowest mean and standard deviation of fluctuations computed by alternative formulas as the criteria for the formula which best achieves the objective of reducing fluctuations. A secondary criterion, if the first does not distinguish clearly among two or more formulas, is that formula which most nearly approximates the preferences of local government officials.

A comparison and mean and standard deviation can be simply stated. It is necessary, however, to amend the criteria slightly because large fluctuations in opposite directions, positive and negative, may cancel out to yield a very small mean (but a large standard deviation, which measures dispersion around the mean).

MEANS AND STANDARD DEVIATIONS OF FLUCTUATIONS PRODUCED WITH CONSTRAINTS

	EP 3-4		EP 4-5	
	Mean	Standard deviation	Mean	Standard deviation
Constraint plus or minus 10 percent	+6.0	4.0	+7.3	3.0
	−7.6	3.2	−7.1	3.6
Constraint minus 10 percent	+31.0	243.7	+13.0	19.5
	−7.7	3.1	−7.3	3.5
Constraint minus 10 percent needy	+21.6	49.3	+13.1	24.9
	−13.7	13.5	−11.2	10.7
Constraint smoothing	+11.4	26.1	+13.1	17.8
	−9.8	10.4	−11.2	12.1

The ±10% constraint is clearly the best in terms of the criteria in both EP 3–4 and EP 4–5. Since the constraint is structured to keep all fluctuations with 10% limits, the sum of each mean and its standard deviation is close to 10% for positive and negative changes in both periods.

The selection of a second best constraint is based on the secondary criteria: a constraint which most nearly approximates the form preferred by local government officials. The questionnaires and interviews leave little doubt that one of the preferred choices in the −10% constraint. That choice is a little chilled by the table above showing a positive mean and standard deviation in EP 3–4 far higher than any other. It appears, however, that this errant mean is largely the result of a wild upward movement in tribal fluctuations. The −10% figures for EP 4–5 are quite good.

Chairman BOLLING. Thank you very much.

Well, Mr. Musgrave, it's your turn.

STATEMENT OF RICHARD A. MUSGRAVE, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. MUSGRAVE. Let me say, Mr. Chairman, first of all, that I did not have a chance to read the papers in advance, and therefore cannot really do justice to the excellent work that has been done; I can merely try to sum up, perhaps, to come back to some of the general issues which have been raised in the various papers.

I would say that Mr. Jesmer's topic is a somewhat separate one, whereas the other three are more related to each other, especially the Strauss and Stephens discussions. Mr. Jesmer dealt with the topic of how neutral can the system be made with regard to State and local fiscal behavior, but one point which he made that ties in with the other discussion is the rigid two-thirds/one-third division between State and local shares that would not allow for differentials. That point overlaps with the other two papers.

So, perhaps we can focus, to begin with, on the problem raised by the Strauss-Stephens discussion, which would seem to be what ought to be the pattern by which the funds are distributed from the State down. It's interesting and good, I think, that these papers deal with this, because in the earlier discussion—if I'm not mistaken—in the congressional deliberations and in the discussion of the press, practically all the focus was on the problem of distribution among the States, and what the formula should be like, what should be put into it, and how it would affect the urban States versus the rural States and so on.

The whole discussion of the distribution of funds from the State down has had a much lower profile, and hardly anybody knows what the rules are; and if there are any they haven't been brought to the public's attention. So, I think it is very fruitful to look at that aspect of the problem.

If I understand it correctly, it is a much more complicated problem than that of distribution between the States because when it comes to distribution between the States, they are all similar governmental units, so that one can focus on the question of what weight does one want to give to fiscal capacity, to need, and to effort, and to the desire to influence State and local tax structures and so forth.

Having decided on weights, the next question is: How do we measure need, weight, and effort; and whether the present indexes are adequate? Undoubtedly they can be improved, and I take it you talked to some extent about that yesterday. So you have examined the question of how redistributive or not the revenue sharing formula should be, and if it is to be redistributive, how it can be done best.

When we get to the question of allocation from the States down, we still have all these problems with us. There is again the question: To what extent should there be redistribution between lower level jurisdictions, allowance for capacity, need, effort, and all these things? All these problems are all still there in an accentuated fashion.

But in addition, you now have the problem of the structure of jurisdictions being different among the different States. Therefore, if the money is to be passed through the States, can any one formula really do the trick in all situations? As far as the distribution of funds between States is concerned, one can simply say, "Mr. Congressman, give me your objective, how much weight do you want to give to this and that, and we will write you a formula which does it." It might be five pages long, but the computer will handle it anyhow. Any results you want can be translated back into a formula which then applies as between all the States. But when it comes to dealing with differential structures of jurisdictions from the States down, it becomes much more difficult to devise one single formula which makes sense in all situations; and assuming that you don't want to give incentives to force the various States into a common jurisdictional structure, away from their traditional leanings, if you want to accept them, then there is much to be said for the common trend in today's papers; namely, that there need to be somewhat more flexibility in the passthrough arrangements.

Again the problem has to be divided into various parts. First, there is the overall division of funds between the State and local level, which is now uniform across all States. The various papers have proposed that it should be made more flexible. If one wants to be neutral about the degree of fiscal centralization within the State, this is a good idea. The breakdown between State and lower level should depend on the distribution of functions, and this differs among States. Otherwise, one addresses himself to the average State which, as you point out, doesn't exist because the "average" is so heavily influenced by New York and California. So, I think that is one problem to consider.

Having determined the State-local division there is the problem of whether we should have this double step of first allocating from State to counties, and then by using another formula, from the counties on down. As Mr. Strauss' paper points out, there is an interdependence between these various levels of allocation because otherwise the whole thing just might not add up. Because of the 20-percent rule there may not be enough funds with the given allocation between counties, so the latter would have to be changed. It doesn't make much sense to fix the allocation between counties if this does not permit us to achieve the more meaningful objective further down.

So, there is the further question of whether one would want to have more flexibility in the distribution between counties and the lower levels.

Since the pattern is so distorted by the major urban centers, one might well consider whether they should not in fact be taken out; whether the 10, or some more or less arbitrary number of major cities should perhaps not be taken out of the total picture and be dealt with outside the States from the Federal level, and whether that, then, would make it easier to deal with the remaining problem.

So, Mr. Chairman, I would suggest that we begin addressing ourselves to the question of whether everyone is agreed that a more flexible view should be taken of the State-local breakdown, and if so, by what pattern that should be done. Would one take the last year or the last 5 years of State-local revenue proportions, or how would one do that. I suggest that the other people who have thought about this much more than I first comment on this question. Then we could go to the next question, dealing with the distribution formula, from the States down, and how might that be changed.

Chairman BOLLING. That is a valid question, and an interesting question, too. I would be interested in your comments. Who would like to start?

Mr. JESMER. I would like to start by trying to show a difference between the State and local government in relation to their relative responsibility, and treating them in relation to the one-third/two-third split. Our proposition is nonneutral—I hate to use the word—because we are supposed to be neutral.

We are nonneutral in relation to local government, and we feel that the one-third/two-thirds split on a national basis should be made, although it varies from State to State, depending upon relative responsibility that State and local government has in the State. And the way to do that is by a system of weights, which just automatically brings it back to a one-third/two-thirds on a national basis.

I think it goes without saying that the most important part of the distribution is the distribution to States because if you can't get it to them in the correct kind of a way, then you can't do anything within the State in a correct kind of a way.

Mr. MUSGRAVE. But if you gave them weights of one, in other words, the existing pattern, what would it be at the national level?

Mr. JESMER. We are assuming the existing interstate formula, so that the State, as a State unit, receives the same relative amount as they do now; not the State government, the State area.

Mr. MUSGRAVE. Yes. And then, if you leave the distribution between States, but distribute within the State according to the distribution of responsibility, then, how would it come out nationally?

Mr. JESMER. It takes a weighting formula of 2.41 in relation to the local government adjusted revenues.

Mr. MUSGRAVE. But I want to put it the other way around. Suppose you simply told each State to distribute in line with the present distribution of responsibilities, and then apply that formula to the existing distribution, then you would come out in the same way in which now State and local fiscal resources are.

Mr. JESMER. That depends on the measure that you use.

Mr. MUSGRAVE. The tax concept.

Mr. JESMER. Right, is it taxes, is it revenues, is it expenditures.

Mr. MUSGRAVE. And if it's revenues?

Mr. JESMER. If it's revenues, the relationship is pretty close to 50–50.

Mr. STEPHENS. Well, it depends on the major use.

Mr. MUSGRAVE. But then, if it is 50–50 and you want to be neutral, why do you want to make it 66–33?

Mr. JESMER. Well, that really puts the bacon in the fire. Our conception of it is that local government has a greater need for the funds than the State governments do; they have greater need, and they are more constrained by their ability to work on expenditures, work on programs, and also to receive revenues. The local government is preempted from the revenue point of view by both the Federal Government and the State government as far as flexible revenue scheduling is concerned.

Mr. STEPHENS. I would like to disagree rather violently. [Laughter.] I don't think the local governments are downtrodden third-level government. The measures we use are reasonably accurate—depending upon which ones you are talking about—and there is about a 50–50 division of responsibility for public service.

If you weighed both revenues and expenditures on the average, and the States do heavily support local government—your State of New York and my State heavily support local government. They (local governments) do have a narrow tax base, but you also get several times as much in State aid as in Federal aid. A considerable proportion of their budget is out of State aid. The States have not let them go, and in some way there is the implication that local governments have really been had.

Also, in terms of service delivery, if you used say, expenditures, which is one way of calculating it, as the means for distribution, you are going to hurt very badly those States like Wisconsin and Minnesota that leave the service delivery to local government, but local governments are heavily State funded. And you get that sort of variation for many States.

But overall about two-fifths of the per capita expenditure is State-provided services; and about two-fifths are locally provided. There is a 20-percent range where it varies as to whether it is State or local. And you get quite a lot of variation among the States.

Mr. MUSGRAVE. Are you saying that you should not use weights, but own revenue, rather than expenditures?

Mr. STEPHENS. I'm saying we should use combined revenues and expenditures, partly because the revenues give the State bias: the expenditures give the local bias. You take both of them into account, who provides, and who delivers public services.

I'm saying don't use either expenditures, or financial responsibility.

Mr. MUSGRAVE. But which would you weight more?

Mr. STEPHENS. I would weight them the same.

Mr. STRAUSS. I think it's obvious that everyone agrees that the one-third/two-thirds is rather different from what goes on State by State; and I think it has been increasingly apparent since World War II that the State governments are more important.

Second, if you shape a formula to pattern State-local responsibility on revenues and expenditures, you are essentially saying that current practice is desirable and acceptable vis-a-vis the health of our federal system. If renewal contains a pattern of split between State and local governments on the basis of revenue or expenditures, it will amount to saying current practice is appropriate. Whether or not this is what is most desirable for the health of the federal system is a separate issue we haven't addressed, and one which Congress might want to address because the Congress is the Federal Government, the central government that is sharing the funds with the States and localities, and they have some interest in the overall health of the federal system.

Finally, in terms of the history of the debate on the one-third/two-thirds, the sentiment as I saw it in front of the Finance Committee was that local government really had greater financial problems in 1972 than the States. The concern was that the States were not doing their part in helping them out. That's by way of history.

I am on both sides of whether or not you should punish State governments for not taking care of their children; it is the case that counties and municipalities are constitutional creatures of State government and they either permit them, or do not permit them to raise taxes in the State.

But at least in terms of debate in 1972, the perception then was that States had fewer problems because of the greater access to taxes.

Mr. MUSGRAVE. Now, let me follow up on your hint as to the health of the federal system, which was to allow for this difficulty. Do you take the view that we want to weight local more heavily, or against it?

Mr. STRAUSS. Depending on how I feel on a particular day, it would be either the State government, or the local government. I guess today I would——

Mr. MUSGRAVE. On the average.

Mr. STRAUSS. On the average, I guess—without weights—I have a little more sympathy for local governments.

Representative LONG. When you are feeling neutral.

Mr. MUSGRAVE. So, you would go to a somewhat heavier weight on the local side.

Mr. STRAUSS. Yes.

Mr. MUSGRAVE. If you did that, would you base that on the revenues, expenditures, or on both?

Mr. STRAUSS. There are many technologies available to do that. One is that you can use noncapital expenditures, because most States spend very heavily on highways, which are periodic. And as a matter of fact, if you wanted a two-thirds State and local split——

Mr. STEPHENS. Let me ask you about taking capital out, that bothers me a little bit because if you look at the input side of the expenditure matrix, State services are much more heavily cash and capital oriented than are locals; and why should you have that kind of distortion?

Mr. STRAUSS. I think one concern might be that you don't want large fluctuations from year to year. States spend a lot of money for higher education, and spend a lot of money on highways, and make big investments that could lead to a bulge in the State and local split. That might be undesirable because you want a stable relationship.

Mr. STEPHENS. But you could average these things over time.

Mr. STRAUSS. Surely.

Mr. LUSTIG. Of course the bulges are worse in small local governments; when one has to buy a fire engine, or has to put a wing on a community building total expenditure may double; State government's range in the size of capital expenditure year by year is relatively small; and I think that is true of large cities, too.

Representative LONG. May I take off on that question on a little different tack, and that is an inquiry of all of you, that if you saw really unanticipated results from the formula that has been applied, this goes directly to the capital expenditures of local government.

I have seen a couple of instances where, in order to make a capital expenditure, and not being sure of the continuation of the program over a long period of time in this uneasiness that they have, that they have held their money, put it in the bank, and then, when they got enough so that they felt reasonably safe they were going to be able to finance their way out—and this is particularly true in some very poor areas—they would make a very substantial capital expenditure.

But in the meantime, while they had that money in the bank—and there was one instance in a very poor area, they had something over $1 million in the bank. And during the period that they were accumulating that million dollars, right up to about the time they got the million dollars in the bank, a couple or three local tax issues came up. These were new ones for schools, or new ones for other purposes; or a continuation of the existing tax bond issues.

And the opponents of the bond issue used the fact that this million dollars was in the bank, even though it really was not related at all, there was no relationship at all. But they in a demagogic way used the fact that the parish government, as we call it in Louisiana, had a million dollars in the bank and said, "Why in the world should we go and impose additional taxes on ourselves when they've got a million dollars sitting there in local Banker Jones' bank, drawing interest?"

And they really had in mind building a new jail with it, which they desperately needed. I think this is a result that was not anticipated at all when they were setting this forth. And for that reason I ask you if you have any similar examples of unanticipated, what we might call political results because this, in those areas, can cause a very bad situation.

Mr. STRAUSS. I can give you the reverse of that in North Carolina.

Representative LONG. Right.

Mr. STRAUSS. I recall a phone call from a poor part of the State from some people who were concerned that funds promised for a school were in fact to be used for a jail, which was contrary to what they wanted. And what they did was, in the next election, run a bunch of people against the board of commissioners and threw them out. You may consider that a happy political result——

Representative LONG. It depends on whether I was in, or out.

Mr. STRAUSS. That's right.

Mr. LUSTIG. Well, one Mississippi county had a reverse of the situation you are talking about. The only school in the county burned out, and in three successive elections the voters had refused to approve a bond issue to rebuild the school. It was only when the county got revenue sharing money that they were able to build that school.

Representative LONG. To carry on with our example, what happened here is that as a result of the defeat of these three bond issues that were up at the time, the sheriff's offices, which are elected offices in the State of Louisiana, are financed by a percentage of the—they are sheriff and tax collector—they receive a percentage of the amount of taxes that they raise.

So, what has happened is, the bond issues have expired, and consequently the taxes are no longer due. They have just found themselves in horrible trouble with respect to their ability to finance their own operations because they are not included in the amount of money that goes under the revenue sharing; and on the other hand, the amount that they had in the part has been undercut because of the effect of the revenue sharing money being in the local financial institution.

The fact exists, when they do this capital accumulation it becomes a self-defeating type of instrument in that what they do is defeat all their own taxing power and consequently undercut their own formula to enable them to continue to participate in the program to the same degree and the same percentage somewhere down the road, the way the percentage worked out.

Mr. JESMER. One correction, of course, would be to make the formula, or the operation more certain for a longer period of time, then the municipality could have obligated itself now to build something because it knows full well the funds will be there.

Chairman BOLLING. How do we do that?

Mr. JESMER. Well, this has a 5-year life; another bill could have a 10-year life.

Chairman BOLLING. Well, I think the Congress is getting less and less sympathetic to that long a commitment. I may be in error, I may have missed the point; but my impression is, on one end we are developing a budget system which advised more and more planning—if I may use the right word, even though it is considered "dirty" by many—and on the other hand there are an increasing number of committees, it seems to me—and maybe I'm in error—who are moving off to a 1-year authorization kind of thought. If that type thinking, that type psychology is there——

Mr. STRAUSS. First of all, I think there is a trade-off between annually giving funds to those most needy and also providing certainty. Meeting needs annually requires getting and using very current data.

Yet, the way to assure certainty is not to change the data more than once every 3 years because what is happening is that as some tax efforts go up and other tax efforts go down, there are shifts over time in allocations to localities. Currently the Office of Revenue Sharing updates the tax data annually; and they update the population income data every 3 years.

I think a reasonable compromise between these two desires, certainty and meeting immediate needs would be to update all the data at once, but only every 3 years. So, the locality would know for 2, or 3 years what it is getting; and then plan accordingly.

It is very difficult annually to pick up this microdata on population and income. The States have tremendous difficulty in their school aid programs.

Representative LONG. Right.

Mr. STRAUSS. And their sharing of State sales taxes, or gasoline taxes. This bill is really unique in that it provides for updating. The Census Bureau recently came out with the new 1972 population and the 1972 per capita income data.

I think what might be fruitful would be to freeze these numbers for a period of about 3 years, and then maybe renew it over a 6-year period. So, you would have two looks at it.

Chairman BOLLING. Is the implication that the figures are good enough to use, but not so good that a 3-year gap would make much difference?

Mr. STRAUSS. I think it is a reasonable compromise between the different goals that we are trying to achieve. I think waiting 10 years, use the 1970 census until 1980, is too long a period; and I think annual updating is too frequent because of the uncertainty it creates.

Mr. MUSGRAVE. But if you had annual data you would have a moving average, that would be preferable to every 3 years.

Mr. STRAUSS. That's right.

Mr. MUSGRAVE. The changes would be quite small. So, I take it your case for 3 years is really based on practicality.

Mr. STRAUSS. Yes. It takes the Census Bureau a couple of years to collect the data.

Representative LONG. You do that by a combination; you give it the stability by carrying it for, say a 3-year period, and then go on to the averaging formula. That would satisfy both.

Mr. STRAUSS. The averaging formula. If I may, I'd like to return to the very difficult issue you raised vis-a-vis the renewal, and that is the mechanism for funding.

Chairman BOLLING. Well, given my whole view of the whole thing, I fundamentally, from the point of view of representative process, oppose the program. And then, for the program in the immediate future because I have no rational alternative for reasons that I think are relatively clear, given my own history. I worked on an attempt to rationalize the committee jurisdiction of the House for a couple of years and had a major failure on it; in other words, I got beat.

Therefore, I don't think that the chance of having a really effective categorical program is very real. I am locked into a system that is working to a degree. I am not an opponent of revenue sharing for the short run, but I could very easily be an opponent of revenue sharing in the long run if I saw alternatives that I thought were better, recognizing the political fact that the States, the localities and so on are hooked. I mean, they are on the program to such an extent that you would have to have a very real alternative to be much more attractive to them to have any political ability to shift off the program; which leaves me, I suppose, with the ability to be relatively objective about the whole program.

Mr. STRAUSS. One possibility might be to have these annual amounts subject to the budgetary process, to raise them or lower them for an aggregate fiscal need; but not to review annually the very details of the program, which could lead to a really extended appropriations process. And then adjust the amounts allocated in general revenue sharing to meet the macrogoals that Congress wants for the budget.

Chairman BOLLING. Somewhere we are going to have to fit the whole business of the impact of the general economy, the general economic situation, the very severe impact of that on what? It is a greater impact on localities, municipalities than it is on States, presumably. It is surely a much greater impact on those than on the Federal level, for reasons that are pretty obvious.

But how do we think about this conceptually in terms of the countercyclical need, if any? I happen to think they are clear.

Mr. STRAUSS. You could vary the amount for general revenue sharing proportionally; it could be countercyclical, to have a base, as this one has.

Chairman BOLLING. Well, would it be valid to use the same formulas for the countercyclical than for the normal general revenues?

Mr. MUSGRAVE. The difficulty is that in the formula, we have per capita income and we have population, and we have effort; but we don't really have capacity. We don't really have fiscal capacity.

Chairman BOLLING. Right.

Mr. MUSGRAVE. And it is the fiscal capacity that varies differentially, depending on the tax bases which different jurisdictions have.

Now, if there was something for fiscal capacity in the formula, such as the revenue from a standard tax base, or something of that sort, then one would get more variation.

Chairman BOLLING. And of course, something like that would make me much more comfortable about the whole program.

Mr. MUSGRAVE. If you could have that, you would not really have to recompute what happens to standard revenue for every village every year, but you could use an index for what happened to various types of tax bases and make an approximate adjustment; and then you would get more flexibility into the distribution.

If I may say, when revenue sharing was introduced, it was really the child of a misalliance. There were the liberal Democrats who thought that, look, they are going to have a tax cut, and that is just too bad; and let's get that revenue out to States and localities where it's spent in the public sector, and that is the important thing, we don't really care how we get it out. This was essentially, if I may say so, the philosophy of my good friend——

Chairman BOLLING. They wanted to find a way to use up the dividend.

Mr. MUSGRAVE. They wanted to use up the dividend, that was it, that's right.

Representative LONG. Some people would describe that product of the misalliance as an illegitimate child.

Mr. MUSGRAVE. That is right; yes. But of course, illegitimate children may turn out to be charming. [Laughter.]

Representative LONG. That's true.

Mr. MUSGRAVE. On the other hand, conservatives liked the idea because you reduce the size of the Federal Government and build up State and local governments, the whole idea of decentralization. And in between these two things, the real objective—of what I think ought to be the real objective of the whole thing; namely, to realine, get a better balance of fiscal capacities and needs, got sort of last. And that has to be brought in, a better measurement of capacity and need, not only over the cycle, but also generally. And that is what is important to get an allocation among the jurisdictions at the lower levels.

Mr. STRAUSS. It is a very practical problem, getting figures from localities.

Mr. MUSGRAVE. Yes. But we could do better than we do, and that might be a very constructive way in which this committee, the Joint Economic Committee could get into the act; namely, to develop the kind of data, research program which the census ought to do, to permit this to be done better. I think that would be a very constructive thing.

Mr. STRAUSS. I agree with you.

Mr. JESMER. On that point, Mr. Chairman, the current distribution formula provides an index of 336 percent of adjusted taxes to those places that have a poverty level where 30 percent or more of the people are at that 125-percent poverty level.

Or, to look at it another way, those places that have incomes below $2,000, there is a national index of 354 percent of adjusted taxes; that is against a standard of 100, that is just the current formula, though. In terms of countercyclical activity, that is very strong.

Chairman BOLLING. Right. Now, there is another thing that we haven't pursued, that interests me, and that is the business of perhaps taking the great cities—I'm not sure that's the right word—taking them out and treating them differently. That was, to me, a very interesting thought, but it wasn't pursued, and I don't know exactly how to get it pursued.

Mr. MUSGRAVE. Let me add a word on that, since I suggested it. It seems to me that the special financial problems which have arisen in the big cities are really national problems.

Chairman BOLLING. Accurate.

Mr. MUSGRAVE. In other words, there is no reason why a wealthy man in West Chester should be held responsible, financially, for the fiscal problems of New York City any more than a wealthy man living in Arizona because to a considerable degree these problems are problems which have resulted from national policies and national trends. So, I think they should be taken off the States' shoulders and the burden should be equalized amongst States which might not have these particular problems. I think it could be done.

The difficulty with it is not so much to adjust the formula, a pattern can be devised for doing it; but the difficulty is to protect oneself against losing all fiscal discipline in the city. Now they are still part of the State, and they have to defend their position in the State legislature, and people look over their shoulders.

If the responsibility was national, then the burden would be distributed so widely and this control would be lost. The basic question, coming back to the matter of fiscal federalism, is really whether you can have sound fiscal federalism if jurisdictions spend money which they don't have to raise. As New York City shows we have a serious problem here.

Now, it may not be a matter of spending money wisely if the costs of the expenditures are fixed. The trouble comes from effects on the costs of public service, such as the salary structure in public employment. Things of that sort pose a discipline problem because if larger national support is assured why not raise wages in New York City; who cares.

Chairman BOLLING. That is exactly right.

Mr. MUSGRAVE. So, it needs some supervision.

Chairman BOLLING. Well, you got to the "guts" of a problem that I am thinking about.

Now, I agree, No. 1—I was born in Manhattan; grew up in north Alabama; I have represented Missouri for a long time—and I know from my own experience the enormous diversity of the country. I think it is very desirable to try to encourage the continuation of diversity; and that it is very desirable not to homogenize the States. I think for reasons that I would have to call "political" in the broadest sense, these diversities are very important to the quality of the society, real and potential.

On the other hand, I feel very strongly that the great cities, the big cities, are not solely the responsibility of the State and of themselves because they make so great a contribution to the national culture, if I can put it that way, which seems to me terribly important.

I think you have made it very clear that there is a conflict, and it really is a discipline.

As soon as you embark on this program, you have made it impossible for my constituent—whoever he may be—to call to account everybody involved in the actions of his representative. When I vote on this program, I defuse. I defuse—and you can pun on this very easily—I defuse the power and responsibility, and defuse the political effect.

Mr. MUSGRAVE. That's right.

Chairman BOLLING. And you have a situation where you are making the process of representative government curiously irresponsible: and at the same time you are trying to encourage certain aspects of the differences within a complicated society.

It seems to me this may be the crucial problem, philosophically, which you have to deal with in this particular program.

Mr. MUSGRAVE. I totally agree. I would only add that the cities not only make a large contribution to the national life, but it is also that national policy, or lack of national policy, places a tremendous burden of residual problems on these cities to deal with problems that perhaps ought to be taken care of nationally.

Mr. STEPHENS. And the inaction, if you want to say so, of the Federal Government dealing with the problems on a national level.

Mr. MUSGRAVE. It's a residual problem.

Chairman BOLLING. And we have the situation of the magnetic attraction of the big cities to people who cost more and provide less, that is sort of inevitable. I don't know what the figures are, but it must be clear, where the advantages of local services are greater, people are going to go when they find out about it.

Mr. MUSGRAVE. And State policy, like school integration, fine and justified as they are, they are not undertaken nationally, but the fiscal implications which they may have are left for the cities to deal with.

Chairman BOLLING. That is right.

Mr. STEPHENS. I want to comment on making these megacities, or whatever you want to call them, State areas. I did a very brief analysis of that, and it has some side effects. One is, it very drastically cuts the State share of general revenue sharing in States affected.

Another aspect is in trying to define large cities. If you take New York City, that's fine. It is very clearly defined. But if you take Chicago and use just the city, you've got all sorts of overlying and surrounding governments, and it simply isn't comparable in a local governmental structure to New York City. Now, even if you take the county area, then you can get something comparable between Los Angeles——

Chairman BOLLING. Can you?

Mr. STEPHENS. Yes, and Cook County, and New York City.

Chairman BOLLING. I wouldn't have thought you could do Los Angeles, it's so widely out of phase.

Mr. STEPHENS. No, it's about as comparable as you can get, if you take the county area, and all of the governments within.

Chairman BOLLING. That is interesting, I wouldn't have thought that.

Mr. STEPHENS. And there would be a very drastic reduction, particularly in these States, of what goes to the State government.

Chairman BOLLING. But if I understood what Mr. Musgrave has said, he would treat them, he would extract them and treat them entirely separately and you would end up—let's just say for fun—60 States. You have 50 States, and there would be 10 more, that would be treated as States.

Mr. STEPHENS. It still comes out somewhere.

Chairman BOLLING. Of course it does. It would reduce of course, divide into the 60 whatever you have. Now, what would be the effect of the figures? They say you are getting a substantial chunk.

Mr. STEPHENS. They are getting a substantial amount.

Mr. MUSGRAVE. The effect one might expect would be that people in West Chester would have to pay less State taxes which go to support New York City, because part of that burden would be assumed by people living in Arizona.

Mr. STEPHENS. Are you sure of that?

Chairman BOLLING. That's what I am curious about.

Mr. STEPHENS. I wouldn't have that kind of expectation. What is it New York City gets from New York State now, about $4 billion, on that order?

It gets 55 percent more per capita than other local governments from the State. I don't think it works out that way. But you know, I haven't gone through a very complete analysis on this. I looked at it primarily in terms of what it does to State and local government generally, not specifically.

Mr. MUSGRAVE. I would expect it to result in a redistribution of burdens because the burden of State taxes which now go into the cities, are distributed differently, regionally, from the Federal taxes, which would be a substitute.

Mr. STEPHENS. You are going to have a big reduction in what the States get because you can use, I presume, the same formula, and New York would get less.

Mr. MUSGRAVE. Yes, they would get less.

Mr. STEPHENS. Will that affect their willingness to give $4 billion for New York City? I don't know.

Mr. MUSGRAVE. This would depend on whether New York City would get more under direct revenue sharing than it gets now from revenue sharing via the State. So, it would depend on, really, how these new "States" would be entered into the overall formula.

Mr. STEPHENS. But without a change they might go down in net, that is what I am saying.

Chairman BOLLING. Of course the other problem that has to be related, and I certainly don't know how to, is the taxation in a place like the city of New York. I haven't studied it, but I gather not only are the State taxes relatively progressive in New York, very progressive. There aren't many States as progressive as New York and one or two others are.

Then I take it that the local taxes in the city of New York, the boroughs, and so on, are very high, compared to other local taxes, so that you've got a whole sort of factors in terms of effort in there that would probably put New York and California all by themselves, almost, in terms of local, State, and other taxation. I don't have any idea what Chicago and Illinois would look like.

But you would have, apparently, a very high effort, and a total lack of an equitable increase in capacity, the kind of increase in capacity that would make sense when compared to other jurisdictions. In other words, a person of a certain income in a particular place in the city of New York must have a much higher tax burden than practically anybody else in the country. And that is a question of some kind of an equity that one has to look at, even in the Federal system.

I'm sure of that, but then it becomes a political problem. The more service is available—but the service is not necessarily for the people that are paying the taxes, and it sets up another set of population flow.

Mr. MUSGRAVE. It's kind of a double problem, if you consider it. If one argues that to some extent these fiscal burdens and needs are national responsibilities, then, if they were taken out and put separately into the revenue sharing program and received a larger share than they now do via the States, then the question is, what would be the effect on the regional distribution——

Chairman BOLLING. Right.

Mr. MUSGRAVE [continuing]. How to share in this burden. And obviously Arizona would come to share more than it does now, and West Chester less than it does now.

And the second question is, what would it do to the progressivity?

Mr. STEPHENS. But, you know, some of New York City's problems are self-generated.

Mr. MUSGRAVE. Of course they are.

Mr. STEPHENS. And I think that is something we must take into consideration. It's not everybody can provide a higher education system for 260,000 students, and things like that, free.

Chairman BOLLING. And not everybody can supply the kinds of pension programs for local employees.

Mr. STEPHENS. They have a bureaucracy set in concrete.

Chairman BOLLING. I have a suspicion that not even that jurisdiction can do that.

Mr. MUSGRAVE. Mr. Chairman, I would note that the discussion of revenue sharing in the United States came on us more or less suddenly. It has been carried on in kind of a vacuum because the problem has been discussed in many countries of the world for many years. Australia has a long history of distribution of Federal funds. There is kind of a judicial process where States come and claim need for support, and other States show cause why they should not pay into the kitty; and there is this annual adjudication procedure. Switzerland has a tremendously detailed and elaborate system; Canada has, and many, many countries have, which are aimed at this kind of horizontal fiscal equalization. And I think that one could learn a good deal from what these other countries are doing.

Chairman BOLLING. That's right.

Representative LONG. And to the extent to which they play a part in the national planning becomes a related question that is really extremely interesting.

Mr. MUSGRAVE. Yes, sir.

Mr. SCHLOSSTEIN. The question that you raised about horizontal equity raises some interesting questions about Mr. Stephens' view of federalism, which is that everything should go through the States. I wonder how you would deal with the problem, the theory that each city should compete in its own political arena in the States.

Now, since we are dealing here with Federal funds which presumably should be treating like situations equally, how do you deal with a situation where in one State a city of the exact same size, exact same per capita income, and exact same tax effort fares very well and in another State a city with the same traits fares very poorly? Does that in any sense offend your sense of horizontal, or political, or economic equity?

Mr. STEPHENS. Oh, in a sense it does. But I could fall back on the Federal system and say basically that's a problem of intrastate distribution. Although, I don't know; we have situations I have looked at, in terms of need at least—which Mr. Musgrave was talking about—where you look at what is going to individual local governments in, say, in 10 city metropolitan areas, and I can't tie it very easily to what they really need. There are some that seem to me rather gross inequities, even though we are using this formula.

Mr. SCHLOSSTEIN. That's not addressing the question.

Mr. STEPHENS. I know it's not, but it is saying in part that intrastate distribution is a State function.

Mr. SCHLOSSTEIN. Yes; that is true when you are dealing, I think, with State funds. But when you are dealing with Federal funds, at least from a political standpoint it's awfully hard for a Congressman from Kansas City, for instance, who has a situation very similar to Minneapolis, and one of them is receiving twice as much revenue sharing funds as the other.

Mr. STEPHENS. Well, I mean, this would happen if you did it on the basis of performance. You would have very different amounts of money going to Minneapolis, as opposed to Kansas City; or Honolulu, as compared to some other city, partly because of the role of the State.

I mean, that part would be in there if you kept the same local distribution formula, but shifted the State and local distribution. Do you see what I mean?

You still have variations by cities because they are doing different things. I mean, when you just look within the State of Missouri, for example, I know of municipalities where the only thing they do is write zoning ordinances. They are not very active. But then you have Kansas City and St. Louis who are doing an awful lot more. You get very wild variations relative to what they are doing.

Mr. MUSGRAVE. Could we ask this question, apart from whatever else were to be done rearranging the whole system, just looking at the narrow context, is there any good reason for insisting on this rigid two-thirds/one-third, rather than make some adaptation? It seems to me nobody here has argued for that.

Mr. STRAUSS. One could argue that is an optimal relationship between State and local government.

Mr. MUSGRAVE. Yes; in other words, unless you believe——

Mr. STRAUSS. I'm not arguing for it.

Mr. MUSGRAVE. Suppose you did believe in a two-thirds local role, we would then like to use the revenue sharing apparatus as an incentive to have State and local fiscal arrangements moved toward that. But this rigid two-thirds/one-third does not provide such incentive because it does not affect the total which they get.

If we wanted to do that, then we should add another component to the formula, such as the percent from income tax; namely, something measuring how close you are to the two-thirds/one-third division, and let that enter into the total. Even if you want to do that, the rigid breakdown would not help. So, there is really no argument for it.

And that would simply leave the question, if you wanted to relax it, how would you best do it as between using revenue expenditures, and so forth.

Mr. STEPHENS. The only real argument would be brought out by political negotiations, that would prevent some hassles, maybe. I don't buy it, but——

Mr. MUSGRAVE. That's not academic, that's not our part.

Chairman BOLLING. That's right, that is something else.

Mr. LUSTIG. With respect to the treatment of the large cities, I was wondering if it makes sense to try to use general revenue sharing to perform so many special functions. It might well make more sense to use general revenue sharing as a kind of relatively evenhanded treatment across the board, and use block grants for special purposes. Federal or State acceptance of financial suport for all forms of public assistance would also give relief to our cities, especially large cities. It is unlikely that one system of distribution of money can successfully perform a lot of special tasks.

Mr. SCHLOSSTEIN. Well, the income redistribution is left over for revenue sharing.

Mr. MUSGRAVE. That is one aspect. But the fact is that revenue sharing is here. And revenue sharing, being here, will grow. And if there are some limits to the transferability of Federal funds, maybe we are using them for the wrong purpose.

So, revenue sharing isn't all that harmless because the existence of general revenue sharing does not necessarily mean that the total transfer is larger; it might mean that it's transferred in a nonoptimal fashion.

Mr. LUSTIG. I think that at present many large cities are getting less money than they were getting under the categorical grants for revenue sharing.

Mr. MUSGRAVE. That is correct. On the one side, the extreme degree of specification and strings which we had in the provisional category grant programs gave good cause for criticism of many programs. Simplification was needed. But on the other side, revenue sharing was applied as a pretty general, flat, overall distribution without concern to anything, either programs or equalization. Maybe what we really need is an approach that falls within the two, that is not quite of the categorical grant type and is less specified as to types of services; but at the same time more pointed and less shotgun type with regard to need and capacity.

Mr. STRAUSS. I would like to make this observation. It's easy to say that there is no political responsibility in general revenue sharing funds. But I think it is also important to observe that, as compared to other grant aid programs this goes through budgets, this goes through elected officials; it doesn't go through agencies with appointed officials that answer to no one, that is a big difference. And that represents a fundamental change in the way we give grants to States and localities. That ought to be borne in mind because it creates the possibility of local political accountability whereas before that didn't need to be the case.

Mr. MUSGRAVE. There are two aspects to the local fiscal responsibility. One is, how is the legislature spending the funds. And as you point out, they do go through a legislature. The other, which I had more in mind, was effects on cost. If unions know that outside funds will be provided somehow, then they can escalate needs by raising wages; and the legislature is less in a position to stop that. Just like a businessman will grant wage increases if he knows he can pass this thing on in higher prices.

Mr. STRAUSS. But the evidence, as I understand it—and I have not looked recently at this very carefully—there hasn't been a lot of wage inflation. By and large you are talking about something between 10 and 15 percent added to the budget, and that is not the kind of margin that leads to huge wage increases. If anything, it has forestalled layoffs last year and this year. It is not a recession problem.

Mr. MUSGRAVE. But if you had a more need-capacity-oriented grant system, then I think that situation could develop.

Mr. STRAUSS. Sure.

Mr. MUSGRAVE. Perhaps it has not so far.

Chairman BOLLING. I think we are getting to the point where I think we need to do some cleanup on some questions that need to be asked. I think Mr. Long and I have a problem that is upcoming. As far as I know, they are still going to act on that veto.

Representative LONG. Yes.

Chairman BOLLING. So, I think we'd better give you a shot at some questions that I think you may have.

Mr. SCHLOSSTEIN. I just wanted to ask one question of the panel that I think Bob Strauss brought up in his statement, and that is the situation in Illinois where he felt that the existence of the revenue sharing program had actually hindered a seemingly needed reform of the governmental structure.

I wonder, first of all, if all of you agree that the existence of the general revenue sharing program has in some ways contributed to a proliferation of governments that may not be strictly efficient units of general service government.

Second, if that is the case you might be able to offer some suggestions that would focus the program more on those units of government that are indeed providing general services, or for lack of a better word, "viable political jurisdiction."

Mr. JESMER. I looked at it in Indiana, and the situation I saw wasn't general revenue sharing, it was the effect of the 20-percent limit. And what it was doing to those constrained units was to provide them exactly twice as much money in terms of adjusted taxes as municipalities would receive. And when the limits came off in that State, the indexes returned to normal kinds of shapes. So, it was just the effect of the 20-percent limit.

But in the interviews in Indiana with the State officials and the local officials, they do indicate very strongly that it has shut off the movement in Indiana to change the form of that type of local government. And I agree, they are not general purpose types of local governments; they have some very minor responsibility for road upkeep. The per capita expenditures are down around $10, $5 per year.

Representative LONG. I think it has led to a proliferation of them, or at least a continuation of them.

Mr. JESMER. A retention.

Representative LONG. A retention of what might have otherwise died. I hadn't thought of this before, but everybody relates things to their own particular area, as I do. In the last 2 years, there have been two little towns incorporated in my congressional district. And I think before they got the incorporation papers down to the secretary of state, they sent a letter to me, wanting to know where their revenue-sharing funds were. [Laughter.]

I really hadn't thought of it in relationship with this.

Mr. STEPHENS. Some people have said that this would happen with small communities. I don't know of any documentation, other than what you have just said.

Mr. STRAUSS. I worried a great deal about this for fear that communities would sprout up like mushrooms after a rain. One thing holding this down is that a lot of States have minimum population requirements, they have certain classes of cities.

Second, the tax effort factor in the formula, except for the 20 percent, would require a locality, to get any kinds of funds, to incur a burden of taxation, and therefore provide some services. So, these are two things that sort of kept down the mushrooming of communities. It hasn't, however, encouraged really changing the way that States and localities relate.

And in some respect this may point to the fact that the State governments have not taken the kind of interest that they should in providing leadership in redefining their relationships to localities, or how localities relate to each other.

And this is why, on balance, if I had to worry about which, the State or local government had greater needs, in some respect I favor local governments, because the States have not shown the kind of leadership that they have to if decentralization is to be successful.

Chairman BOLLING. Anything else?

Representative LONG. May I make one comment in that regard? It is the general feeling that many of us have—and I served for 1 year as the Assistant Director in the Office of Economic Opportunity—and it was our feeling at that time that one of the things the Government should do was a regionalization; and I personally still think it is probably needed in order to make it more efficient a form of government of one type or another, comprehensive plans of transportation, and comprehensive plans of all these related items. That perhaps this is not going into a phase of that, even if it is not resulting in a proliferation of additional towns.

And if this concept of regionalization of effort is a valid concept, that we might be fighting an uphill battle here against that in trying two concepts, one in direct conflict with the other. And that perhaps ought to be given some serious consideration.

Mr. STRAUSS. I think that the Federal Government has a legitimate interest in the organizational forms of State and local governments:

how you motivate people and what's appropriate. Those are very difficult questions.

Representative LONG. Right.

Chairman BOLLING. Gentlemen, I thank you all. This has been, I think, a very stimulating discussion. We are grateful to you for the efforts of preparing your papers and coming to participate.

With that, the subcommittee will stand adjourned, subject to the call of the Chair.

[Whereupon, at 11:55 a.m., the subcommittee adjourned, subject to the call of the Chair.]

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