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STATEMENT OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON REVENUE SHARING,
INTERGOVERNMENTAL REVENUE IMPACT, AND ECONOMIC PROBLEMS
SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of this distinguished Subcommittee:

My purpose today is to discuss the President's proposal for a new Revenue Sharing Program. The proposed bill, S. 2574, the "Local Government Fiscal Assistance Amendments of 1980," was submitted to Congress on April 16, 1980. It expresses the President's continued commitment to the principle of general fiscal assistance.

The current Revenue Sharing Program is funded through fiscal 1980 at an annual rate of \$6.9 billion. Since the Program was enacted in 1972, one-third of the payments have been allocated to State governments and two-thirds to localities. The need for a balanced 1981 budget has caused the President to propose that, in the future, no Revenue Sharing payments be made to States. The future Program would involve, therefore, only payments to local governments. These would be made at the rate of \$4.6 billion annually, the present level, and be distributed on the same entitlement basis as the current Program.

As you know, persistent inflation continues to be our nation's most pressing economic problem, and the Administration has redoubled its efforts to reduce it. A central element of the intensified anti-inflation program is greater fiscal discipline, leading to a balanced Federal budget in fiscal year 1981. To achieve that balance, the Administration has proposed to reduce 1981 outlays by \$17.2 billion. It was necessary to eliminate funding for Revenue Sharing payments to State governments as part of this outlay reduction. The need to cut Federal spending to reduce inflation must take precedence.

Revenue Sharing payments currently represent about 1.1 percent of the total general revenues of State governments. The States have a far greater ability than localities to absorb a loss of this magnitude, given both their current financial condition and their legal authority to adjust revenues and expenditures.

However, the loss by State governments of \$2.3 billion per year in Revenue Sharing payments is likely to force them to cut back their own payments of aid to local governments. To assist localities, especially those experiencing the most fiscal stress, in adjusting to the reduced amounts of State aid, the President has proposed that an additional \$500 million in transitional assistance be paid to local governments in fiscal years 1981 and 1982.

Why Revenue Sharing?

Before turning to our recommendations for the new Program, let me review the history of Federal Revenue Sharing. The Program was first enacted in 1972 to redress a "fiscal mismatch." Federal taxes were perceived to be more equitable and responsive to economic growth than the taxes levied by State and local governments. At the same time, it was believed that the demands for State and local government services were rising more rapidly than the demands for the services provided by the Federal government.

Many changes have taken place since 1972. It is no longer true that State and local--and particularly State--revenue systems are inferior. They have made major strides in broadening and refining their tax systems so that they are more equitable and more responsive to economic change.

At the same time, it is no longer clear that expenditure demands are rising most rapidly at the State and local level. For instance, the pressure for increasing education expenditures at the State and local level has eased. At the same time, the aging of our population presents the Federal government with rapidly escalating outlays for social security and medical care.

Because of these trends, the underlying rationale for Revenue Sharing needs to be reconsidered, and the Program adapted to changed circumstances. A "fiscal mismatch" remains the overriding problem. But the mismatch is quite different from the one addressed by the original Program.

The primary fiscal problem of the American federal system today is the imbalance between resources and responsibilities at the local level. Many local governments in our nation have responsibilities for providing public services that are disproportionate to the fiscal resources to which they have access.

The objective of the new Revenue Sharing Program must be to ensure the access of every general-purpose local government to fiscal resources in reasonable proportion to its responsibilities for providing public services.

Fiscal imbalances are due in part to the workings of our economy. In some cases, the resources of local governments are inadequate because their economies are declining or lagging behind growth in the rest of the nation as industry shifts to other areas. This is a continuing problem in many areas of the Northeast and upper Midwest. In other cases, resources are inadequate because the locality's economy is underdeveloped. This problem is especially acute in the South and in many rural areas throughout the nation. Neither of these reasons for inadequate fiscal resources is easily overcome by local initiatives, or even by State action. Revenue Sharing is essential to enable localities whose economies are weak to provide adequate levels of public services.

The Administration's proposals are designed to relieve the fiscal problems of the most acutely stressed local governments. This will be accomplished by improved targeting of Revenue Sharing payments to local governments making an above-average tax effort and whose residents have below-average incomes. With Revenue Sharing relieving the most serious disparities, the States will be able to devote their energies and resources to addressing the underlying structural sources of local fiscal problems. Treasury will be monitoring the extent to which the Revenue Sharing Program continues to assist State governments to fulfill their responsibilities for solving local fiscal problems.

Better Targeting of Revenue Sharing

The heart of the Revenue Sharing Program is the formula that allocates funds to over 39,000 local jurisdictions. This formula is generally sound. However, our analysis over the past two years has indicated that certain modifications should be made to ensure that the distribution of funds makes a consistent contribution to the reduction of disparities in local fiscal capacities. Briefly, under the proposed legislation:

1. Current procedures for distributing funds among States remain unchanged. These procedures allocate resources in accordance with general patterns of need and are based on carefully wrought compromises between a host of legitimate political interests. However, the \$500 million in transitional assistance in fiscal years 1981 and 1982 will be allocated in proportion to the current amount of aid provided by each State to its general-purpose local governments.

2. The essential logic of the intrastate distribution formula is valid and should be maintained. However, the formula has been adjusted so that higher levels of funding are directed toward full-service jurisdictions whose residents have comparatively lower incomes and bear high tax burdens.
3. The allocation procedure of the intrastate distribution has been modified so that jurisdictions of comparable size with the same incomes and tax efforts receive the same Revenue Sharing payments.
4. The revised formula is consistent with the principle that virtually every general-purpose local government in the nation should participate in the Program.

These recommendations, although modest, will significantly improve the equity of the Revenue Sharing Program. They are based on discussions with intergovernmental fiscal experts throughout the country, and with officials at all levels of government. The proposal also reflects the conclusions of a year-long review by the Office of Revenue Sharing of the impacts of the current formula and known alternatives, and an additional year of research and development conducted by Treasury's Office of State and Local Finance.

The Proposed Allocation of Local Revenue Sharing Funds

Let me now describe our specific recommendations for a new, five-year Revenue Sharing Program involving \$4.6 billion in annual payments to local governments.

Interstate Distribution

The allocation of funds under the current Program begins with an interstate allocation. Each State (not the State government) receives the higher amount of what it would receive under the three-factor Senate formula (population, relative income, and tax effort) or the five-factor House formula (population, tax effort, relative income, income tax receipts, and urbanized population). This approach reflects a compromise effected when the Program was first approved by Congress. It is particularly important to continue the interstate allocation procedure because the sectional and regional conflicts it resolves may be even more intense today than they were in 1972.

It should be pointed out that these procedures have more to recommend them than the fact that they effectively resolve significant conflicts in our national politics. For example, the Advisory Commission on Intergovernmental Relations reports that the interstate distribution of Revenue Sharing funds is generally consistent with its index of fiscal stress.

Intrastate Allocation of Funds

Once the Revenue Sharing funds are allocated among the States, the intrastate allocation procedure begins. The fundamental strength of the allocation of Revenue Sharing funds rests with this intrastate formula. The key variables of the formula--population, relative income, and tax effort--direct funds among county areas within a State and within each area in a manner that tends to reduce disparities in the fiscal capacities of local governments. In its current form, however, the capacity of the intrastate formula to contribute to fiscal equity is unduly limited in several important respects. Thus, we are proposing several changes.

1. De-Tiering

The current formula first allocates funds to county areas within a State and then to individual jurisdictions within each county. This "tiering" procedure causes some significant inequities in the allocation of funds. For example, low- and moderate-income jurisdictions in relatively wealthy counties receive substantially less funding than they would receive if they were located in a county with a per capita income the same as their own. Conversely, wealthy jurisdictions located in relatively low-income counties receive disproportionately high payments.

To eliminate these inequities, the Administration is proposing to eliminate the initial allocation to county areas. Indeed, all local governments within a State will compete for funds on a common basis. As a result, all jurisdictions with the same income levels and tax efforts in a given State will receive the same level of funding on a per capita basis.

2. Maximum and Minimum Grant

The formula now ensures each locality a per capita Revenue Sharing payment equal to 20 percent of the average per capita payment to all local governments in the same State. The formula also limits per capita grants to 145 percent of the State average. The minimum guarantees a substantial level of funding for all jurisdictions, regardless of their wealth or the scope of their

responsibilities. The maximum limits the funding available to severely stressed jurisdictions; that is, those with relatively low per capita incomes and very high tax efforts.

In order to reduce the seriousness of the inequities introduced by these constraints, the Administration is recommending that the minimum be lowered from 20 to 10 percent and that the maximum be raised from 145 to 175 percent. The 175-percent limitation is needed to avoid directing a disproportionate share of Revenue Sharing funds to large cities in several States. The 10-percent lower limit is appropriate because no single formula change should result in more than a 50 percent reduction in funding.

3. Budget Constraint

Some limited-purpose jurisdictions collect very small amounts of taxes and receive little intergovernmental revenue. For such governments, the minimum-payment provision results in payments sufficient to finance a very large proportion of their budgets. To limit these governments' dependency on Revenue Sharing, the current formula restricts the amount of the grant to 50 percent of a jurisdiction's total adjusted (non-education) tax collections and intergovernmental revenues (not including Revenue Sharing). This provision is commonly referred to as the budget constraint. As this constraint is currently defined, Revenue Sharing is financing one-third of the budgets of more than 500 jurisdictions. (In contrast, Revenue Sharing finances less than 6 percent of the budgets of all local governments.)

As presently constituted, this provision has provided a strong incentive for the preservation of limited-purpose jurisdictions. Every increase of a dollar in local tax revenue or intergovernmental transfers received by such a locality, if the minimum payment is limited by the budget constraint, qualifies it for an additional 50 cents in Revenue Sharing funds.

Reduction of the minimum per capita payment from 20 percent to 10 percent will reduce the significance of this inequity, but no government receiving the minimum should be able to finance more than a fifth of its budget from Revenue Sharing. Thus, we are recommending that the budget constraint be reduced from 50 to 25 percent. This recommendation is in keeping with the principle that no single formula change should result in more than a 50 percent reduction in any locality's funding.

The reduction of the budget constraint necessitates a complementary formula change. Under the current formula, funds not allocable to a city or town because of the budget constraint are assigned to the county government that overlies the jurisdiction.

If the county government is also constrained, the funds are allocated to the State government. Since State governments will no longer be eligible to receive Revenue Sharing, the Administration is proposing that these funds be reallocated to unconstrained local governments throughout the State.

4. Scale-Down for High-Income Jurisdictions

From the beginning of the Revenue Sharing Program, concern has been expressed that wealthy jurisdictions receive excessively large payments. Many very high-income communities now receive Revenue Sharing payments that cannot be justified by any reasonable concept of need. This is thoroughly inconsistent with the fundamental objectives of the Program. Thus, we are proposing that the Revenue Sharing entitlements of very high-income jurisdictions be scaled-down, at a moderately more rapid rate than the current formula provides, by an amount that increases with the income level of the jurisdiction.

This can best be accomplished by the following formula modification: for each jurisdiction with a per capita income higher than 115 percent of its State's average, the jurisdiction's tax-effort factor in the formula will be reduced by somewhat more than the percentage that its per capita income exceeds 115 percent of the State average. The rationale for initiating the scale-down at 115 percent is to limit the effect of the provision to the wealthiest 10 percent of all local governments.

5. Normalization of Adjusted Taxes

The current Revenue Sharing formula credits several hundred relatively small jurisdictions with very high tax effort, but in actual fact their citizens are not subject to onerous tax burdens. These jurisdictions are "tax enclaves" that export very large proportions of their taxes. In order to normalize the tax efforts of such jurisdictions, the following formula modification is proposed: the adjusted taxes included in the calculation of tax effort for a jurisdiction will be reduced by one dollar per capita below 250 percent of the per capita adjusted taxes of similar jurisdictions in the State (counties, cities, or towns) for each dollar that its per capita adjusted taxes exceed 250 percent of that statewide average.

This provision would not apply to a jurisdiction with per capita adjusted taxes under \$250, or to a jurisdiction that is the sole local government for its geographic area (for example, a city-county government). The \$250 limitation is designed to protect counties and townships that provide fairly high levels of services in States where the overwhelming majority of similar

governments provide only very limited services. The sole-government limitation protects jurisdictions whose taxes are high simply because they are responsible for services that are provided by two or more overlying jurisdictions elsewhere in the State.

Overview of the Impacts of the Formula Modifications

In the aggregate, the proposed formula changes will shift approximately \$228 million among local governments (about 5 percent of total payments to localities). In terms of net impacts: cities, Indian tribes, and rural counties realize the largest gains; urban counties experience modest losses, and townships fairly significant losses. Computer printouts detailing the consequences of the Administration's proposals for every local government in the nation have been made available to this Subcommittee.

In general, the formula changes will increase funding for large cities, and will improve the responsiveness of the allocation to variations in tax effort and per capita income. Wealthy jurisdictions will experience substantial reductions in funding. Payments to a majority of the nation's 105 largest county governments, typically suburban jurisdictions, will be reduced moderately; a few very high-income counties will experience large reductions. Lower-income counties will experience moderate gains. Small towns and poor rural jurisdictions that offer a full range of local services will be provided additional funds.

The consequences of the formula changes vary from State to State depending on interactions between local government organization and geographical patterns or demographic structure. For example, the impacts on major cities tend to be different in the Northeast and Midwest from those in the South and Southwest. In the Northeast and Midwest, most very large cities have relatively low per capita incomes and much higher tax efforts compared with the rest of their States, and especially compared with their surrounding suburbs. As a consequence, they will experience increases in Revenue Sharing funding under the revised formula, often at the expense of their suburbs. In the South and Southwest, many cities have per capita incomes significantly higher than the rest of their States. Consequently, the new formula shifts Revenue Sharing funds from these jurisdictions to relatively poor, high-tax-effort jurisdictions, often in the rural areas of those States.

Compliance Requirements

Under the present Program, no recipient may discriminate on the basis of race, color, national origin, sex, age, handicap, or religion in activities funded by Revenue Sharing. In

addition, recipients must hold public hearings on their budgets to provide their residents an opportunity to comment on proposed appropriations of the Revenue Sharing grants. The Administration recommends continuation of these compliance requirements.

Jurisdictions receiving annual payments totaling \$25,000 or more must have an audit in accordance with generally accepted auditing standards at least once every three years under the present Program. The Administration proposes to require an audit of every year's books conducted at least once every other year during the new Program.

Transitional Assistance

The termination of Revenue Sharing payments to State governments, beginning in January 1981, will reduce State revenues by \$2.3 billion per year. Revenue Sharing is a relatively minor component of State budgets--averaging 2 percent of their total tax receipts. Nevertheless, the loss of Revenue Sharing payments to State governments is likely to result in substantial reductions in the aid that the States provide to their localities.

Reliable estimates of the likely losses in State aid are not available for most individual local governments because the fiscal impact analysis necessary to identify the magnitudes of such losses has been done in only a few cases. For the same reason, estimates of the aggregate losses to all localities in each State are also unavailable. However, a recent study commissioned by the Treasury Department of the fiscal impacts of terminating Revenue Sharing payments to the States concludes that the total loss to local governments nationwide may be as large as \$1.4 billion.

Accordingly, the Administration has recommended that an additional \$500 million be distributed to all local governments along with their regular Revenue Sharing payments in fiscal years 1981 and 1982. The objective will be to give local governments time to adjust their financial plans to the loss of State aid.

Even though estimates of direct local losses of State aid are unavailable, we expect that the losses will be most severe in States where aid to local governments is a large proportion of State government budgets. On the other hand, in States where such aid is a less important factor in State budgets, the local losses are likely to be relatively minor. Accordingly, the Administration is proposing that the \$500 million in transitional assistance be allocated among the States in proportion to the amount of aid that each State government pays to its general-purpose local governments for purposes other than education. For

example, if a particular State accounts for 5 percent of all State aid to general-purpose local governments in the country, that State will receive 5 percent of the \$500 million, or an additional \$25 million in 1981 and 1982.

The transitional assistance will be added to each State's share of the \$4.6 billion in regular Revenue Sharing payments. The total amount allocated to a State will then be distributed among all general-purpose local governments in the State by the revised Revenue Sharing formula.

This procedure for allocating the transitional assistance was designed to ensure (1) that the funds will be distributed to local governments in States where the loss of Revenue Sharing is most likely to reduce State aid to local governments, and (2) that the distribution of the payments within each State will favor the fiscally stressed local governments that are most likely to need help in adjusting to the loss of State aid.

Conclusion

The President believes, and I believe, that through Revenue Sharing we can address the fiscal problems of local governments in the 1980's, and build a firm financial foundation for the future of government in America. A vital and responsive federal system should be a national priority. But setting priorities, and finding ways to meet them, always require debate. I hope my appearance here today will contribute to that debate.

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