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REVENUE SHARING: IMPLICATIONS FOR THE  
NINTH FEDERAL RESERVE DISTRICT

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## REVENUE SHARING: IMPLICATIONS FOR THE NINTH FEDERAL RESERVE DISTRICT

A new era in fiscal intergovernmental relations began on October 20, 1972, when President Nixon signed into law the "State and Local Fiscal Assistance Act of 1972" or the "Revenue Sharing Bill" that will provide state and local governments \$30.2 billion between 1972 and 1976. This paper examines the need for revenue sharing, compares revenue sharing to other forms of federal financial assistance, reviews the recently enacted revenue sharing plan and ascertains its impact on Ninth District state and local governments.

### 1. THE CASE FOR FEDERAL ASSISTANCE TO STATE AND LOCAL GOVERNMENTS

#### U.S. Federalism: Distribution of Powers and Responsibilities

The United States as a federal union is governed by a constitution that distributes powers and responsibilities between sovereign national and state governments. The Constitution enumerates the specific powers of the national government and grants the states all powers neither delegated to the national government nor prohibited to the states. Many of today's important civil governmental functions such as education, welfare, and public health are not mentioned explicitly in the Constitution and have traditionally been considered residual powers of state government. Local governments are created by the state. States, in general have delegated many of their civil functions to local governments, but the particular relationship between state and local governments varies nationwide.

The power distribution between levels of government shifts in response to changes in the social, political, and economic environment. In recent years, for example, the federal government has assumed a much larger role in fulfilling civil (or domestic) governmental functions. In the thirties, states were unable to cope with the relief and welfare problems brought on by the depression, so these functions were transferred to the federal government. The federal government assumed additional responsibilities for civil functions during the Great Society programs of the sixties.<sup>1/</sup>

Although the federal government has become increasingly involved in civil governmental functions, most civil functions are actually executed by state and local governments. As Table I indicates, 76.7 percent of all final civil governmental expenditures could be attributed to state and local governments in 1970.<sup>2/</sup> This figure is slightly lower than figures from 1902 and 1927 when state and local governments were given an even greater share of spending responsibility. If state and local expenditures are analyzed on the originating level, a similar drop in the state and local share of expenditures appears. Between 1963 and 1970, federal payments to state and local governments doubled; however, the state and local share of expenditures, on the originating level, remained essentially unchanged.

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<sup>1</sup>A more detailed discussion of the history of federalism in the U.S. can be found in Chapter I of Financing State and Local Governments by James A. Maxwell, The Brookings Institution, Washington, D.C., 1965.

<sup>2</sup>Civil government expenditures are classified according to final and originating level of expenditure in order to avoid a double counting of intergovernmental payments. Classifying an expenditure by its final level indicates that the expenditure is attributed to the unit of government making the final disbursement; so a federal highway grant, for example, is counted as a state expenditure under this classification. Classifying an expenditure by its originating level indicates that the expenditure is attributed to the level of government at which it originated; so a federal highway grant under this classification would be counted as a federal expenditure.

Table I  
 Relative Distribution of United States General Expenditure for Civil Functions  
 by Level of Government, Selected Fiscal Years 1902-1970

Level of Expenditure	1902	1927	1938	1948	1963	1970
Intergovernmental Payments Charged to Level of Government Making Final Disbursement						
Federal	18.5	16.5	36.6	33.0	26.4	23.3
State-Local	81.5	83.5	63.4	67.0	73.5	76.7
Intergovernmental Payments Charged to Originating Level of Government						
Federal	19.1	17.9	42.1	39.7	36.1	36.9
State-Local	80.9	82.1	57.9	60.3	63.9	63.1

Source: Maxwell, pp. 14 & 241.  
Governmental Finances in 1969-70, Table 2, p. 17, Table 3, pp. 18-19.

### Growth of State and Local Expenditures

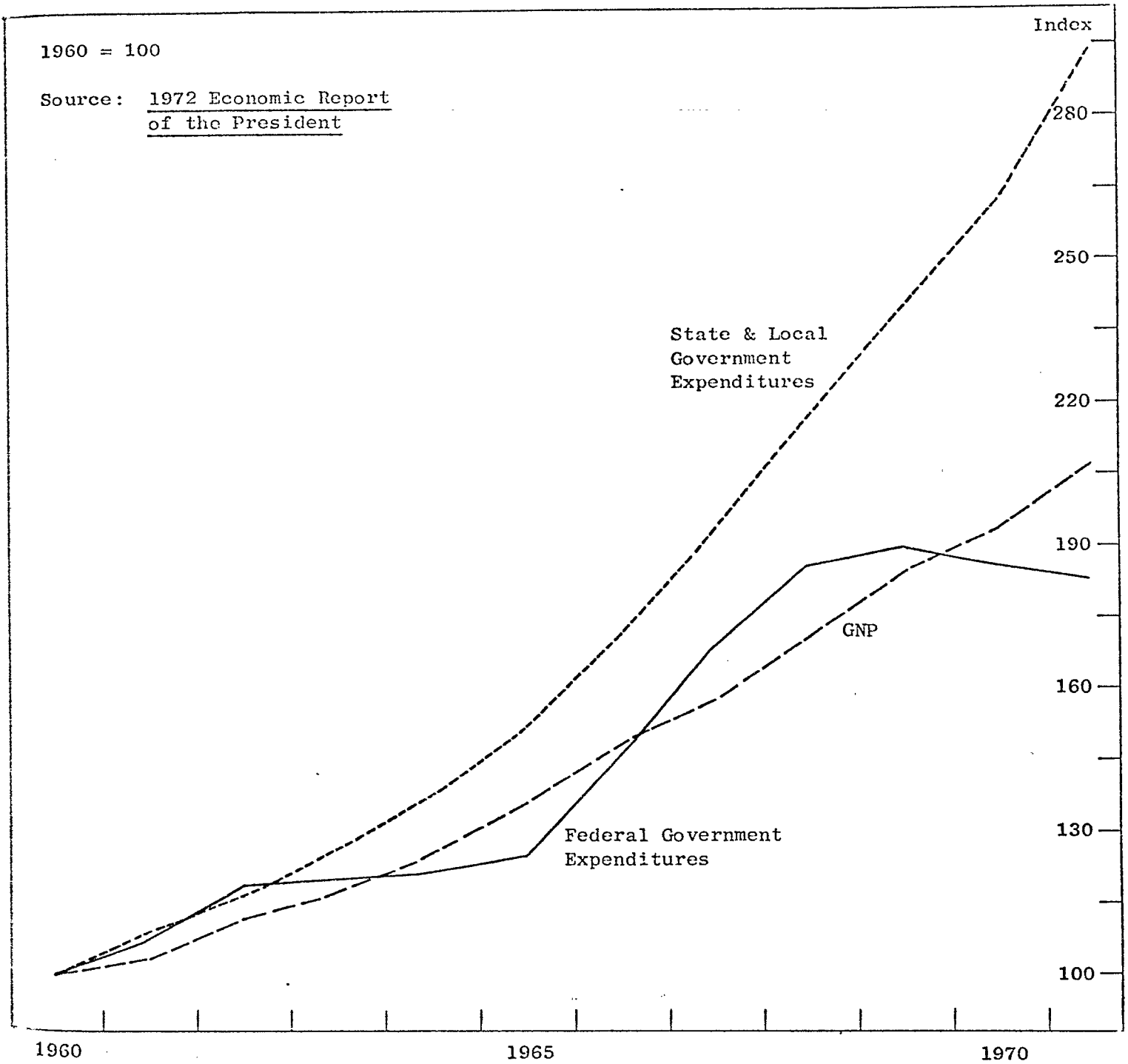
Growth in civil governmental spending has substantially exceeded overall growth in the economy, which makes state and local government one of the national economy's fastest growing sectors. Chart I shows the growth in state and local government expenditures, in national government expenditures, and gross national product (GNP) between 1960 and 1971. During this period state and local spending grew at a 10.3 percent annual rate, compared to a 6.9 percent annual growth rate in GNP, and a 5.6 percent rate in national government spending. Outlays for such traditionally public functions as education, highways, health and hospitals, public welfare and general administration accounted for the rapid rise in state and local spending.

A comparison between Ninth District state and local government spending and nationwide spending shows that Michigan, Minnesota and Wisconsin approximated the national spending rise of the sixties; Montana and South Dakota increased spending at a 7.5 percent annual rate; and North Dakota at a 5.7 percent rate. In terms of per capita outlays, state and local government spending in all district states--except South Dakota--was above the U.S. average. Per capita expenditures in fiscal 1970 exceeded the national average by 13 and 7 percent in Minnesota and Wisconsin respectively; by 5 percent in Michigan and Montana; by 2 percent in North Dakota; but fell below the national average by 1 percent in South Dakota. These figures tend to indicate that the level of governmental services is somewhat higher in Ninth District states.

The relative distribution of expenditures in district states differed from national distribution patterns: District states tend to spend more on education, highways, and welfare than the entire U.S., but spend less on

Chart I

GROWTH IN STATE AND LOCAL GOVERNMENT EXPENDITURES  
AS COMPARED TO  
GROWTH IN FEDERAL GOVERNMENT EXPENDITURES AND GROSS NATIONAL PRODUCT



medical and health services and police protection. The district's less populated and less industrialized states--North Dakota, South Dakota, and Montana--spend relatively more for highways than the other district states.

#### Factors in Spending Increases

The substantial growth in state and local spending can be ascribed to four highly interrelated trends: First, population increases. In particular, large gains in dependent segments of the population--school-age children and the elderly--have necessitated greater outlays for education, welfare, medical and other services. Between 1960 and 1970, the U.S. population increased 13 percent; but, the growth rate for the dependent segments during this period was even more tremendous. The growth rate for the school-age children segment was more than double the growth rate for the total population. And, the number of people over 65 was 21 percent greater in 1970 than in 1960.

Second, the trend toward urbanization and suburbanization. U.S. citizens are highly mobile, but their movements from rural to urban areas and, within urban areas, from central cities to suburbs have swelled state and local government expenses. These population shifts require substantial investments to provide adequate services--police and fire protection, public welfare, public housing, and health services. The proliferation of automobiles and trucks accompanying the population shifts necessitates large outlays for highway construction and maintenance.

Third, affluence. Per capita income has expanded very rapidly in recent years. Affluent citizens demand more and better public services commensurate with their higher standard of living. Parents, for example, want better schools and higher quality education, and encourage their children to stay in school longer. A more affluent and leisure-oriented population also expects expanding public recreational facilities.

Fourth, rising costs of state and local government services. Costs for civil governmental functions have risen much faster than costs in the private sector.<sup>3/</sup> Although some governmental functions lend themselves to cost cutting, a wide range involve personal contact between government employees and citizens. When dealing with people, it is difficult to economize without impairing the quality of services: there is a limit, for example, to the number of students a teacher can instruct effectively. Consequently, state and local governments have not enjoyed productivity gains comparable to those in the private sector of the economy. Nevertheless, wages for state and local government workers increased 68 percent between 1960 and 1970; wages in the private, nonagricultural sector increased only 48 percent in the same period. Furthermore, the recent rapid growth of public employees' unions has also placed upward pressures on state and local expenditures.

These trends, now beyond the control of state and local political managers, are expected to continue. State and local governments face a difficult struggle with the rapidly rising level of expenditures.

#### Review of U.S. Tax System

How have state and local governments financed this rapid expansion in spending? Tax revenues in the U.S. are raised chiefly by three types of taxes: income, sales and property. Because of historical precedence and experience, each level of government relies primarily on one type of tax as a major revenue source. The federal government in fiscal 1970 received about 84 percent of its tax revenue from the income tax, the states obtained 57

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<sup>3</sup>A more detailed discussion of the problem is contained in the "City Hall Discovers Productivity" by Dan Cordtz, Fortune, October 1971.



percent of their tax receipts from selected and general sales taxes, and local governments collected 85 percent of their tax revenue from property taxes.

Table II outlines the relative composition of state and local taxes for Ninth District states. Reliance upon individual and corporate income taxes, general and specific sales taxes, and property taxes differed in each state. However, the total tax burden of Ninth District states in fiscal 1970 surpassed the national average. Tax burden can be measured in terms of per capita collections or in relation to personal income. Per capita, taxes in Michigan, Minnesota and Wisconsin exceeded the national average; taxes in Montana, North Dakota and South Dakota fell below it. In terms of taxes collected for each \$1,000 of personal income earned, all district states were above the U.S. average. Although their per capita collections were below average, the Dakotas and Montana made an above-average contribution in the personal income earned category.

The problem with the U.S. tax structure is twofold: 1) the revenue productivity of the three major types of taxes is unequal; and 2) the equity of these taxes varies. Tax yields can be changed through tax administration or through alterations in a tax's rate and/or base. However, the basic determinant of a tax's yield and its ability to grow over time is its responsiveness to economic growth. Economists use the income elasticity of tax revenue as a device for measuring tax sensitivity. A tax would be income elastic if when income increases by one percent revenue increases by more than one percent; but inelastic if revenue increases by less than one percent.

The income tax is considered highly income elastic because it grows proportionately faster than income. Progressive marginal tax rates automatically

Table II

State and Local Tax Structure in the Ninth District  
(Fiscal Year 1970)

	United States	Michigan	Minnesota	Montana	North Dakota	South Dakota	Wisconsin
Percent of Total State Tax Revenue Obtained From							
General Sales	29.6	35.3	19.2	--	35.3	42.4	20.5
Selective Sales <sup>1/</sup>	27.3	20.8	26.2	37.4	28.0	41.9	20.1
Individual Income	19.1	17.7	33.9	30.2	12.6	--	36.8
Corporate Income	7.8	8.3	7.8	7.5	2.5	.7	7.9
Property	2.3	3.5	.6	6.3	1.2	--	5.4
Others	13.9	14.3	12.4	18.6	20.4	15.0	9.5
Percent of Total Local Tax Revenue Obtained From							
Property Tax	84.9	91.1	97.5	96.1	96.6	95.6	98.7

<sup>1/</sup> Includes Selected Sales Taxes on Motor Fuels, Alcoholic Beverages, Tobacco Products, Insurance, Public Utilities, Pari-mutuals, Amusements and Other Selected Items.

Source: Governmental Finances 1961-1970  
State Government Finances in 1970

increase the percentage of personal income collected by the federal government. In contrast to the income tax, both property and sales taxes respond sluggishly to economic growth. Studies disclose that these taxes, on the average, are slightly inelastic and just barely keep pace with advances in the economy. Because state and local expenditures have grown faster than the economy, these taxes do not generate sufficient revenues for expenditure requirements. Consequently, state and local governments continually have to impose new taxes or raise tax rates in order to extract more revenue from these sources.

Because of the diversity in state tax structures among district states, their revenue productivity varies considerably. According to elasticity estimates prepared by the Advisory Commission on Intergovernmental Relations (ACIR), Montana's tax structure in 1968--with its heavy reliance on the individual income tax--had an income elasticity of 1.29; the income elasticities of Minnesota and Wisconsin's tax structures were 1.21 and 1.22 respectively.<sup>4/</sup> These three states were among the ten top states for income elasticity. In North Dakota and Michigan, income elasticity approximated 1.0. The only state with an inelastic tax structure, South Dakota (.84), was the only state without an individual income tax.

The U.S. tax structure is not perfectly equitable. Sales and property taxes employed by state and local governments are highly regressive: almost without exception, sales and property taxes take a larger percentage of personal income from families at the lower end of the income scale. The ACIR, for example, has estimated that state and local general sales taxes take 2 percent of adjusted gross income from those individuals whose adjusted gross income lies between

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<sup>4</sup>State and Local Government Finances, Significant Features 1967 to 1970, Advisory Commission on Intergovernmental Relations, Washington, D.C. Report M-50, 1969, p. 67.

\$3,000-\$3,999 as compared to 1.0 percent from those whose adjusted gross income is between \$20,000-\$49,000. Similar figures can be cited for the property tax.<sup>5/</sup> Consequently, district states--Minnesota, Montana, Wisconsin--which rely quite heavily on the personal income tax, probably have a more progressive tax structure than those which depend relatively more on the general sales tax--Michigan, North Dakota, South Dakota.

#### Revenue-Expenditure Gap

Given the existing distribution of civil governmental expenditures and present tax structures in the U.S., a gap between state and local expenditures and revenues has been created. In recent years, general prosperity has increased yields from traditional state and local revenues, thus partially filling the revenue-expenditure gap. Implementation of new taxes and increases in old tax rates have also helped. Nevertheless, despite stepped-up federal assistance, both state and local indebtedness have increased sharply.

State and local taxes between fiscal 1960 and 1970 advanced at a 9.2 percent rate in the United States. Michigan, Minnesota and Wisconsin, which all matched the national spending rise for state and local governments, also matched national gains in state and local taxes. Taxes grew at about a 6.5 percent annual rate in Montana and the Dakotas. To achieve such revenue growth, district states have had to increase tax rates and impose new taxes. In the last eleven years, for example, Michigan adopted an individual income tax and increased tax rates once; Montana increased personal income tax rates three times; Wisconsin five times; and Minnesota twice. Both Minnesota and Wisconsin have imposed a sales tax in the last ten years, and both have already raised rates once. In the same period, Michigan increased its sales tax once, South Dakota

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<sup>5</sup>State and Local Government Finances, pp. 22-23.

raised its rate twice, and North Dakota boosted its sales tax rate three times. All states have increased selective sales taxes on gasoline and tobacco recently. After adopting a corporate income tax in 1967, Michigan has already increased its rate once. Minnesota and Wisconsin boosted corporate income tax rates twice; Montana five times.

By originating new or increasing old taxes, states can help themselves bridge the revenue-expenditure gap. The federal government has also come to the aid of states unable to balance their budgets: in fiscal 1970, federal funds accounted for 16.7 percent of state and local government general revenue, an increase of 5.1 percent from 1960. Federal aid as a percent of general revenue increased between 1960 and 1970 in all district states except North Dakota. In fiscal 1970, federal aid in the district ranged from 12 percent in Wisconsin to 26 percent in North Dakota.

When all else fails, state and local governments relieve financial pressures by forfeiting needed programs or by increasing their indebtedness. By 1970 state and local indebtedness was 105 percent greater than in 1960. The surge of indebtedness in Michigan, Minnesota, North Dakota and Wisconsin closely resembled the national increase. Indebtedness rose 177 percent in Wisconsin during the sixties, which made the 38 percent rise in Montana look measly by comparison.

#### Federal Assistance As a Way Out

Because state and local expenditures are predicted to continue upward in the future, and because past experience indicates that existing state and local tax structures are incapable of financing future increases (without increasing regressive taxes--which are already high--or going in debt), the federal government will have to continue to assist in correcting this misalignment.

If the federal government does not step in, state and local services will probably deteriorate nationwide. (As explained earlier, the Ninth District does not escape this fiscal plight.)

Even if state and local governments' tax structures were to be made more progressive, increased federal aid is still necessary, many contend, because state and local governments differ in their ability to provide services to their citizens. Federal assistance can be used to ameliorate fiscal disparities. It has been argued, furthermore, that the fiscal plight of individual states and localities is a matter of national concern.

Another faction calling for federal aid to state and local governments contends that smaller units of government are more responsive to the needs of their constituents and better able to act upon these needs. Providing federal funds, with no strings attached, would strengthen state and local governments and improve the federal system of government. President Nixon, in his February 4, 1971 Revenue Sharing Message to Congress, used this argument when he stated:

Strengthening the states and localities will make our system more diversified and more flexible. Once again these units will be able to serve -- as they so often did in the 19th century and during the Progressive Era -- as laboratories for modern government. Here ideas can be tested more easily than they can on a national scale. Here the results can be assessed, the failures repaired, the successes proven and publicized. Revitalized State and local governments will be able to tap a variety of energies and express a variety of values. Learning from one another and even competing with one another, they will help us develop better ways of governing.<sup>6/</sup>

This view, however, is not universally accepted and many argue that state and local governments are less responsive than the federal government to

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<sup>6</sup>President's Message to Congress on Revenue Sharing, February 4, 1971.

people's needs. They claim, for example, that the poor, urban dwellers, blacks, and labor unions have found the national government far more responsive over the years than state and local governments.

## 2. ALTERNATIVES FOR PROVIDING FEDERAL ASSISTANCE

Revenue sharing must be compared to other types of federal financial assistance to better ascertain its strengths and weaknesses.<sup>7/</sup> The three alternatives discussed in this paper are: income tax credits, categorical grants-in-aid and the assumption by the federal government of state and local government functions.

### Federal Tax Credit

A federal tax credit, advocated in recent years as a means of alleviating state and local financial pressures, would allow federal income taxpayers to deduct part of their state and local tax payments from their federal income tax liability. A tax credit provides direct assistance to the taxpayer, and benefits state and local governments as well since they could absorb federal credits through higher state and local taxes. The important choices in devising the tax credit plan are: which taxes would be eligible for use as credits; and, what is the maximum value of credit that an individual taxpayer can claim?

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<sup>7</sup>A number of articles evaluating revenue sharing and its alternatives are contained in U.S. Congress, Joint Economic Committee, Revenue Sharing and Its Alternatives: What Future For Fiscal Federalism? Vol. II, Range of Alternatives for Fiscal Federalism, 90th Congress, 1st Senate Session, (Washington: U.S. Government Printing Office, 1967). Other options besides the four alternatives listed in this paper are federal tax deductions, federal tax sharing and federal debt retirement.

The ACIR proposed one of the best known tax credit plans in 1965.<sup>8/</sup> Their proposal would have allowed federal taxpayers to either continue to deduct state income tax payments or to credit 40 percent of their state income tax payments against their federal income tax liability. A very simple income tax credit plan would allow an individual to reduce his federal income tax liability by a certain percentage, providing his state income tax liability was at least the amount of the federal credit. States, under this proposal, would be able to raise large sums free from federal control and would also be encouraged to rely on individual income taxes. To the extent that state and local governments come to rely more on the income tax, the progressivity and income responsiveness of the federal fiscal structure will improve. Advocates of a strong federal system favor a tax credit because it would influence state and local fiscal decisions only on the revenue side of the budget. States could then spend these funds on priority items of their choice.

The major deficiency of an income tax credit is that it would not correct the perverse distribution of income between poor and rich states. Because the amount of credit is a positive function of income, the tax credit approach would benefit richer states more than poorer ones. Some critics fear that an income tax credit would amount to a tax reduction for taxpayers, if states are unable to recoup lost federal taxes through increased state and local taxes. Therefore, although an income tax credit

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<sup>8</sup>This plan is discussed in detail in the report Federal-State Coordination of Personal Income Taxes, Advisory Commission on Intergovernmental Relations, Washington, D.C., Report A-27, 1965. Another excellent source of various tax credits plans is James A. Maxwell, "Tax Credits and Intergovernmental Fiscal Relations." (The Brookings Institution: Washington, D.C., 1962.)



would stimulate statewide tax reforms, it would not equalize tax resources between rich and poor states.

#### Categorical Grants-in-Aid

The federal government is currently supplying funds to state and local governments for specified projects, or "categories," subject to conditions established by federal statute or administrative regulation.<sup>9/</sup> In June 1968 the Congressional Record listed more than a thousand federal categorical grant-in-aid programs, ranging from the Teaching Materials for the Blind Act, first authorized in 1879, to the Demonstration Cities and Metropolitan Development Act, enacted in 1966. Grants to state and local governments under these programs amounted to \$21.9 billion for fiscal 1970, representing one of the larger sources of state and local revenue: \$34.1 billion in revenues came from property taxes and \$30.3 billion from sales and gross receipts taxes.

Grants-in-aid have been used to encourage state and local governments to adopt programs which Congress felt were important. This stimulative character of federal grants was emphasized in the 1955 Kestnbaum Report.

The grant's widest use has been in stimulating states to launch or expand services for which state and local governments are generally regarded as primarily responsible. National funds and leadership have stimulated state and local activity in agricultural education and research, welfare services, public health services, vocational education, to cite some prominent examples.<sup>10/</sup>

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<sup>9</sup> A fairly detailed discussion of the federal categorical grants-in-aid program is contained in Chapter 5, Fiscal Balance in the American Federal System, Vol. 1, Advisory Commission on Intergovernmental Relations Washington, D.C., October 1967, Report A-31.

<sup>10</sup> Commission on Intergovernmental Relations, A Report to the President for Transmittal to the Congress, (Washington, 1955), p. 125. This report is usually referred to as the Kestnbaum Report, so named after its Chairman, Meyer Kestnbaum.

The federal government uses grants-in-aid to influence state and local government spending, and justifies its intervention on the grounds that benefits from many public services "spill-over" from the community in which they are performed to other communities. Because state and local governments have a tendency to pay only for benefits received by their citizens, expenditures for many services would be underfinanced without federal assistance: Community parks and recreational facilities, for example, are usually enjoyed by both residents and nonresidents alike. The geographic impact of either a good or poor education extends considerably beyond the boundaries of a local school district. Likewise, a negative spill-over occurs when a community permits rivers to be polluted or fails to take care of its disadvantaged.

Categorical grants-in-aid are excellent mechanisms for improving and expanding such state and local government services as education, welfare and highways--services of national import. Grants-in-aid also have some equalization effect; some programs use allocation formulas based on population or income.

However, critics contend that current federal government programs interfere with state and local government decision making. They assert that state legislatures have had to divert state money from services not eligible for federal aid, in order to finance services eligible for federal assistance. As a result of spending restrictions, grants-in-aid have failed to provide additional general revenue to supplement state and local tax collections. Experts contend that increased use of grants-in-aid would not significantly affect the incidence of the tax system and could make it less progressive if states and localities secure matching funds by increasing regressive-type taxes.

The large number, variety and complexity of existing grant-in-aid programs bewilder state and local government officials and make it very difficult for eligible recipients to be fully aware of the best program for them. The special revenue sharing programs proposed by President Nixon in 1971 were designed to correct some of these deficiencies in our present federal aid programs.<sup>11/</sup>

#### Federal Assumption of State and Local Functions

Transferring certain state and local governmental functions to the federal government is a third alternative for rescuing states from financial quagmires. A proposal that the federal government assume all state and local welfare expenditures, for example, has received considerable attention. Since welfare expenditures have risen twice as fast as total state and local government expenditures between fiscal 1966 and 1970, and in 1970 accounted for 12 percent of all state and local government outlays, this option is understandably appealing.

By transferring functions to the federal government, localities could enjoy services and facilities that would have been substandard if financed only with state and local resources. For example, states whose welfare programs are substandard would, under this program, have their welfare services upgraded. Government services would theoretically be equalized among states. However,

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<sup>11</sup>In six messages to Congress in March and April of 1971, President Nixon proposed six special revenue sharing programs in the areas of law enforcement, manpower training, urban development, rural development, transportation and education. A prominent feature of each was that state and local governments would be relieved of most of the restrictions and conditions of existing aid programs to be combined under revenue sharing. States and localities would be given maximum flexibility and full discretion to determine their priorities and to spend the funds allocated. The application and matching-fund requirements were eliminated and accounting requirements were eased.

special problems arise specifically with the welfare example. In the case of a complete federal assumption of welfare costs, the fiscal relief to state and local governments would be concentrated in those states with large welfare case loads and relatively high benefits. New York, California, Florida, Illinois, Massachusetts, Michigan, New Jersey, and Pennsylvania would receive over 69 percent of the relief. Since these states have 44 percent of the nation's population and receive 49 percent of its personal income, this proposal would not distribute funds evenly nationwide. Similar inequities could be expected with other transfers as well.

Advocates of a strong federal system argue that this solution would erode the powers of state and local government. Another argument against this proposal: it would neither provide flexibility nor allow state and local governments to try out diverse solutions to their individual problems. (This alternative would not result in any marked change in the incidence of our present tax system.)

#### Revenue Sharing

The mechanism advocated by the Nixon Administration and enacted by Congress to improve United States intergovernmental fiscal relations is revenue sharing. Any form of federal assistance to state and local governments could be called revenue sharing, but general revenue sharing funds, unlike grants-in-aid, have no strings attached. The purpose of revenue sharing is to allocate a portion of the very productive and highly elastic federal income tax to the financially pressed state and local governments.

#### Review of Revenue Sharing and Its Competitors

This review of revenue sharing and its alternatives is summarized in Table III which comments on each from the standpoint of fiscal impact on state

Table III

The Impact of Alternative Methods for Providing Financial Assistance to State and Local Governments<sup>1/</sup>

<u>Fiscal Impact on State and Local Governments</u>	<u>Interstate Equalization Effect</u>	<u>Tax Burden Effect</u>	<u>Impact on Inter-governmental Relations</u>
Income Tax Credit	Not as efficient as revenue sharing or federal grants because aid is provided to taxpayer.	It could result in a more progressive tax structure state and local governments would be encouraged to place more reliance on income taxes in order to maximize income tax credit possibilities.	Strengthen states and local governments at the expense of the federal government.
Categorical Grants-in-Aid	Considered an efficient mechanism for achieving national objectives, but tends to distort allocations of funds at the state and local level.	Moderately equalizing.	Federal role definitely enhanced at the expense of state and local governments.
Direct Federal Expenditure Approach	Indirect aid to the extent that the federal government relieves state and local governments of a program.	No marked change in tax incidence.	Federal role definitely enhanced in relation to state and local governments.
Revenue Sharing	An efficient aid mechanism because state and local government can allocate funds among competing needs.	No marked change unless federal money replaces revenues raised by state and local governments.	Federal role diminished state role enhanced.

<sup>1/</sup>This table was taken largely from Table B-1 "A Staff Analysis of Six Alternative Ways of Distributing a Federal Surplus," Fiscal Balance in the American Federal System, Vol. 1, Advisory Commission on Intergovernmental Relations, Washington, D.C., October 1967, Report A-31, p. 313.

and local government, interstate equalization effect, tax burden effect, and impact on intergovernmental relations. In evaluating and weighting these alternatives, it is important to keep the following observations in mind:

- (1) An individual's preference for a particular option is strongly influenced by the role he or she assigns state and local government in our federal system of government. A person favoring strong state and local governments would naturally tend to support tax credits and revenue sharing plans. Such groups as the Council of State Governments, National Municipal League, National League of Cities, Mayors' Conference, and National Associations of Counties have all supported some type of revenue sharing plan. On the other hand an individual who favors expanding the federal government's influence would probably support increasing categorical grants-in-aid or take over of state and local governmental functions.
- (2) Each of these alternatives has attractive features, and if our present system of intergovernmental fiscal relations could be completely overhauled, it undoubtedly would contain parts of each. A complete overhaul is, of course, politically impossible and federal funds are limited. Therefore, the question centers around whether the additional federal assistance to state and local governments which Congress grants each session should go into the traditional categorical grants-in-aid or be used to implement one of the other alternatives.

### 3. REVENUE SHARING: SUBSTANTIAL FINANCIAL RELIEF

#### History

Revenue sharing originated in the late 1950s when a number of prominent individuals spoke out for some sort of general financial aid to state and local governments.<sup>12/</sup> In 1958 a tax sharing plan was introduced in the second session of the 85th Congress by then Congressman Melvin Laird. In 1959 influential spokesmen such as Orville Freeman, then governor of Minnesota, George Meany, president of the AFL-CIO, and others, advocated similar proposals before important audiences. Academics, Walter Heller, later chairman of the Council of Economic Advisors, Harvey Brazier, James Maxwell, Robert Heller, Robert Nathan, and others also evinced interest in revenue sharing. Their early proposals leaned towards federal income tax credits, but, as deficiencies in tax credits became apparent, they were gradually replaced by recommendations for outright revenue sharing.

Neither party officially mentioned revenue sharing during the 1960 presidential campaign; embryonic revenue sharing proposals emerged first during the 1964 campaign. The 1964 Democratic platform was noncommittal and only promised "fiscal policies" to "aid hard pressed state and local governments." But, President Johnson, with the urging of Walter Heller--chairman of the Council of Economic Advisors, committed himself to a tax sharing scheme promising state and local governments "some part of our great and growing federal tax revenues over and above existing needs." Johnson's opponent, Senator Goldwater,

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<sup>12</sup>This section draws liberally on Michael E. Levy and Juan de Torres, Federal Revenue Sharing with the States, Problems and Promises, Studies in Business Economics 114 (New York: The Conference Board, 1970), Chapter I.

was more specific and proposed sharing the federal personal income tax and inheritance taxes with states.

Following through on his commitment, President Johnson appointed a task force on revenue sharing in 1964 headed by Joseph Pechman of the Brookings Institution. Although the task force's report has never been officially released, it provided the basis for much subsequent discussion on revenue sharing and was said to have recommended a revenue sharing plan similar to a scheme proposed by Walter Heller in 1960. This plan would have set aside a certain portion of the personal income tax base and distributed it to states with no strings attached.

With interest in revenue sharing growing, 57 revenue or tax sharing bills were introduced in the 89th Congress (elected in 1964) and 101 bills were introduced in the 90th Congress (elected in 1966). During these years revenue sharing gained the endorsement of the Republican Party and its leadership. The 91st Congress (elected in 1969) received two detailed and influential revenue sharing plans: a proposal by the Nixon Administration and a plan recommended by the ACIR which was jointly sponsored by Senators Edmund Muskie and Charles Goodell. Neither bill was acted upon.

In the first session of the 92nd Congress (elected in 1970), the Nixon Administration reintroduced a revised version of its earlier revenue sharing bill and hearings were held on the bill in 1971. However, Representative Wilbur Mills, Chairman of the House Ways and Means Committee, opposed the Administration's proposal and in late 1971 introduced an alternative revenue sharing plan which was enacted by the House of Representatives in June 1972. The Senate substantially revised the House's revenue sharing scheme and passed an alternative revenue sharing plan in September 1972. A House-Senate Conference Committee in October devised a compromise bill incorporating elements from both



the House and Senate versions. This bill was subsequently enacted by the Congress and signed into law by the President on October 20, 1972.

#### Revenue Sharing Benefits and Drawbacks

Revenue sharing is considered an excellent way to provide general revenue support to state and local governments, because revenue sharing funds are available for general budget support rather than tied to specific activities or programs. Direct transfer without strings leaves state and local governments free to set priorities and to design solutions to their problems. This freedom is especially desirable for low income state and local governments where stringent matching requirements currently imposed on many grant-in-aid programs make it difficult to take advantage of such aid; to match federal aid, states must frequently sacrifice other vital services.

Because the revenue sharing plan calls for funds to be distributed on some basis of population and income, revenue sharing strives to distribute revenues among state and local governments more equitably. Federal revenue sharing provides state and local governments an additional, dependable and continued source of revenue. Revenue sharing advocates further contend that it will strengthen and improve U.S. Federalism by decentralizing decision making and revitalizing state and local governments. To the extent that federal dollars actually replace state and local revenue, this alternative has a slightly progressive effect on our tax structure.

Critics question whether state and local governments are capable of spending these funds wisely. Instead of initiating and expanding desirable services, they might use federal money merely to reduce their own tax efforts. It is further argued that revenue sharing will not contribute to the decen-

tralization of governmental functions, but will cause state and local governments to become more and more dependent upon the national government.

#### The Four Features of the Revenue Sharing Plan

The recently enacted revenue sharing plan can best be described by examining its four major provisions. The first determines the amount of federal funds to be shared. Congress appropriated \$30.2 billion to a special trust fund for distribution to state and local governments over a five-year period. The program begins retroactively January 1, 1972 with a \$5.3 billion distribution in calendar year 1972. This entitlement will rise incrementally to \$6.5 billion in 1976.

The second distributes revenue sharing funds state by state. This provision represents a compromise between the House bill, which generally favored more populous and industrial states and the Senate's plan, which favored less populous states so that each state's allotment is the greater amount available under the two formulas. A three-factor formula allocating funds according to population, state and local tax effort, and relative income works to the advantage of district states such as Montana, North Dakota, South Dakota and Wisconsin. An alternative five-factor formula includes urbanized population and income tax collections in addition to the other formula's three allocators. Minnesota's and Michigan's shares, for example, are computed by this method.

A third provision of the revenue sharing plan is the pass-through system of allocating revenue between a state and its local governments. This provision ensures that states pass on federal aid to localities instead of hoarding it to reduce state taxes or expand state services. One-third of each state's entitlement goes to the state government and the

remaining two-thirds to local governments within the state. The local governments' two-thirds would be divided as follows:

- 1) Allocated to each county within a state an amount computed on the basis of population, tax effort and relative income.
- 2) Allocated to each county government an amount determined by the ratio of its tax collections to total tax collections by all governments in the county.
- 3) Allocated among all township governments within a county a total amount determined by their combined share of tax collections, with each township's amount determined by population, tax effort and relative income.
- 4) Allocated the remainder of the county's share among municipal governments according to population, tax effort and relative income.
- 5) Allocated part of a county area's allotment to the governing bodies of local Indian tribes or Alaskan native villages on the basis of population.

The revenue sharing bill does allow states to adopt alternative formulas for distributing local government funds by population and tax effort or by population and relative income or both.

The fourth provision outlines special restrictions to be placed on the use of revenue sharing funds. States are granted broad discretion in spending their revenue sharing allotment, but they will be penalized if they reduce their financial support to local units. Local units of government are restricted to certain spending priorities. Local governments are allowed to use revenue sharing funds for a capital expenditures authorized by law and for ordinary operating and maintenance expenditures on public safety, environmental protection, public transportation, health, recreation, libraries, social services for the poor and for financial administration. Besides these spending restrictions, all recipients must adhere to several administrative provisions: State and local governments,

for example, must publicly report on the planned and actual use of all shared revenues. Also, discrimination by race, color, nationality or sex is prohibited in any activity or program funded with revenue sharing monies.

Another feature of this bill is that it permits the federal government to collect state income taxes if a sufficient number of states request this service.

#### 4. REVENUE SHARING AND THE NINTH DISTRICT

Given this background, it is now possible to ascertain if revenue sharing is a desirable form of financial assistance for Ninth District states. Based on estimates of relative distribution under each alternative--federal categorical grants-in-aid, federal assumption of state and local welfare expenditures, income tax credit, and revenue sharing (Table IV)--revenue sharing emerges as the most attractive. For a given sum of federal assistance, Minnesota, North Dakota, South Dakota and Wisconsin receive more from revenue sharing plans than from the three other options. Although Michigan would receive more from a tax credit plan, this alternative is not suitable for other district states. The public welfare option is not in the interest of any district state. Montana, North Dakota and South Dakota, however, do quite well, if not better, under the option of expanding existing categorical grant-in-aid programs. But this alternative is not attractive for Michigan, Minnesota or Wisconsin.

Revenue sharing works out to be an appealing option for Ninth District states for three reasons: First, revenue sharing formulas have been designed to award states making an above-average revenue effort; in all district states revenue effort has been above the national average. Second,

Table IV

Allocations to Individual States Under  
Alternative Federal Aid Proposals  
(in percent of total funds)

	Federal Categorical Grants-in-Aid <sup>1/</sup>	Federal Assumption of State and Local Government Welfare Expenditures <sup>2/</sup>	Federal Personal Income Tax Credit <sup>3/</sup>	Federal Revenue <sup>4/</sup> Sharing
Michigan	3.74	4.04	5.02	4.18
Minnesota	1.85	1.70	1.64	1.96
Montana	.56	.23	.25	.39
North Dakota	.36	.20	.18	.37
South Dakota	.42	.20	.19	.47
Wisconsin	1.65	2.06	1.96	2.52

<sup>1</sup>Based on relative distribution of federal aid found in Table 17 of Governmental Finances in 1969-70, U.S. Bureau of the Census, 1971.

<sup>2</sup>Based on the relative distribution of public welfare expenditures found in Table 18 of Governmental Finances in 1969-70, U.S. Bureau of the Census, 1971.

<sup>3</sup>This distribution assumes that all states have a personal income tax and are allowed a credit for state personal income taxes amounting to a certain percentage of their federal income tax credit. This type of tax credit is explained in James A. Maxwell, Tax Credits and Intergovernmental Fiscal Relations, Washington, Brookings Institution, 1962, pp. 184-185. Data used to compute this distribution came from Table 5.1, Statistics of Income - 1969, Individual Income Tax Returns, 1971.

<sup>4</sup>Based on calculations using data from State and Local Fiscal Assistance Act of 1972, Supplemental Report Showing Distribution of Funds Agreed to by the Conferees, prepared by the staff of the Joint Committee on Internal Revenue Taxation, 92nd Congress, 2nd Session, September 27, 1972.

revenue sharing tends to equalize resources among states whereas an income tax credit, for example, would benefit high income states. Per capita income in South Dakota, North Dakota and Montana is considerably below the national average. Their share is much larger under the revenue sharing plan than under a federal income tax credit. Third, unlike federal categorical grants-in-aid, very few restrictions are placed on the use of these funds.

Revenue sharing funds initially will represent a "windfall" to many state and local governments as these monies in many cases were not incorporated into current budgets. The magnitude of shared revenues will not result in any drastic change in state and local finances but rather help offset the rising costs of existing programs and permit some latitude in undertaking new initiatives. Based on general revenues received in fiscal year 1971, South Dakota's allocation will amount to 5.1 percent of general total state and local revenue; Montana's, North Dakota's, and Wisconsin's entitlement to about 4 percent and Michigan's and Minnesota's share to around 3.5 percent.

District state governments in many cases will probably use their revenue sharing funds to increase elementary and secondary school aid and hopefully, to provide some property tax relief. At the local level revenue sharing monies will either be used to defray the cost of existing programs in order to provide some property tax relief or to undertake projects that have been deferred because of lack of funds. In future years, both state and local officials expect revenue sharing funds to diminish the necessity for tax increases.

While the State and Local Fiscal Assistance Act of 1972 provides a new source of general revenue, it also establishes new restrictions for existing federal grant-in-aid programs. A \$2.5 billion ceiling was placed

on federal matching social service grants to state and local governments. Each state's share is limited to the same percentage of the \$2.5 billion as the percentage of its population to total U.S. population. Consequently, state and local governments with large welfare expenditures could conceivably end up losing more in social service grants-in-aid than they will gain from revenue sharing. In a further attempt to restrain state requests for funds, the law requires that no more than 10 percent of state matching social service grant-in-aid funds be spent on programs for persons now on welfare. Exceptions were made, however, for child care, family planning, mental retardation, alcoholism, drug addiction, and foster home programs. Consequently, these restrictions could limit some federal aid that Ninth District state and local governments would have received if the revenue sharing bill hadn't been enacted.

5. CONCLUSION:

State and local government expenditures in recent years have considerably outpaced overall growth in the economy. In order to meet expenditure commitments, state and local governments have raised taxes and imposed new levies, expanded indebtedness, and increased reliance on federal aid. Nevertheless, revenue sources in most states--including Ninth District states--have been strained. Because this problem is not expected to disappear, the demand for federal aid will probably swell. However, by replacing traditional federal categorical grants-in-aid with revenue sharing, additional federal funds could probably be used more profitably. Because of its above-average revenue effort and below-average per capita income, the Ninth District benefits in a net fiscal sense from some form of revenue sharing.

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