Our last speaker was to have been Murray Weidenbaum, who would have given us the gospel on revenue sharing. Murray is being pinch-hit for, if I may use that phrase, by Robert Strauss, who is assistant to the Undersecretary of the Treasury and comes to us by way of Wisconsin. (Weidenbaum prepared paper at end of this session.)

RATIONALES FOR REVENUE SHARING

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Thank you. We may have a third revolution according to Mr. Thurow — we are going to federalize *everything*. I must confess I don't look forward to that day.

In the brief time left, I want to do two things: I would like to underscore the major purposes of revenue sharing — it seems everybody has different goals for revenue sharing. I want to list the goals that I think are pertinent and then comment briefly on some of the criticisms that have been leveled against the Administration's general revenue sharing bill.

I would like to note parenthetically that revenue sharing is alive and well, perhaps despite or not because of this panel, and that I am fairly confident that a revenue sharing bill will be passed by this Congress.

The rationales for revenue sharing are known. They have been repeated for a long time, but I think the one that I want to underscore here is that it will promote political decentralization. I think general revenue sharing represents a conscious effort to shift the balance of federalism towards the states and localities. By shifting untied grants on a regular basis to these units, the states, the counties and cities should more frequently set their priorities and find their solutions to their problems.

This change in emphasis recognizes that it is physically impossible for Washington to keep track of local problems and then tailor present grant programs to meet them. In fact, I suspect the reverse has happened; localities have tried to tailor their problems to fit available categorical grants. Revenue sharing, in my mind, responds to a mounting desire at the local level for people in their cities to control the manner in which public services are provided.

A second rationale for revenue sharing has already been mentioned here, and I want to reiterate it again. That is, that it will plug the states and localities into a more plentiful tax base. Individual federal income tax base responds more favorably to economic growth than does the property tax, and this, in turn, will help meet the fiscal mismatch which states and localities face. And here I respectfully disagree with Mr. Aaron. I think the mismatch is a real one. In this connection it should be pointed out that all of our estimates, all of our forecasts of state and local spending in any category have always been low in retrospect. I think the kind of forecast he refers to in his paper will be proven wrong in 1976.

Thirdly, I think general revenue sharing will, in a significant manner, provide direct relief for hard-pressed cities and state governments. The fiscal crisis is a real one, perhaps not in university towns but I think it exists, and I am quite confident that the Administration formula will meet these crises in these cities.

Finally, I think general revenue sharing will reduce the administrative nightmares of current intergovernmental relations. Those of you who have worked in a city hall or state capitol trying to get categorical grants know about the paperwork, the delays, the uncertainties. I think general revenue sharing, as we have construed it, constitutes a real improvement in this area.

The rationales for general revenue sharing, then, are several: it is an instrument for political decentralization; it provides real gains in administration of intergovernmental relations, both in terms of paperwork and in terms of the reduction of uncertainty; and, finally, it provides fiscal relief to our hard-pressed states and municipalities.

Let me turn now from the broad rationales for revenue sharing to a number of points that critics have made with regard to the pending Administration bill. Several critics have suggested that because the interstate distribution of net benefits is only weakly correlated to per capita income, and that because this relationship becomes weaker when one changes the financing assumptions, the distribution formula is inappropriate and, in some sense, bad.

I think this kind of criticism belies a certain confusion over what the principal goal of revenue sharing is at the outset. As I have indicated, the thrust of revenue sharing is to decentralize government, to help financially pressed governments, etc. Reduction of interstate differences in per capita income is not, per se, a goal of revenue sharing. Putting revenue effort into the interstate formula attempts to distribute funds to those states that are hard-pressed, those states that have higher-than-average tax rates. And in that sense, I think that the administration between states' distributional formula meets its goal.

Let me go on to comment very briefly about the possibility of putting poverty as a measure of need into a distributional formula at the local level. It seems to me this belies some confusion again over the difference between a needy government, a government that can't raise revenues to provide services that it wants to, and an individual who because of his income status may not be able to pay for these services. I would submit to you that if you look at the distribution of poor people by municipality in the United States and you break down the municipalities that you think are in the most trouble, the list is not going to be identical. In fact, looking at alternative formulas, as I have in the Treasury, I concluded that putting poverty into the revenue sharing formula will hurt the major urban areas of the country rather than help them.

In closing, let me merely reiterate that general revenue sharing is an important instrument for decentralization and that the Administration bill, upon close examination, fares quite well in distributing funds to the most hard-pressed units of government. Thank you. (Applause)

CHAIRMAN FITCH: I want to congratulate the members of the panel for having concluded their remarks in such good time. We have about 20 minutes left, during which time we will have two kinds of questions and comments. I would like, first, to invite our panelists to make comments or corrections or biting criticisms about each others' papers, and then for about 10 minutes we will entertain questions to the panelists from anybody on the floor who may feel so inclined. I'm afraid our loudspeaking equipment is fairly well bolted down and the hall is so large that you had better come up here, I think.

MR. AARON: I just wanted to make two very brief comments on Mr. Strauss' remarks. The first is that not only is he aware of the failure of past forecasts accurately to gage expansion in state and local expenditures, but so also are the people who made the forecasts to which I referred. They contained very generous allowances, more generous than in past studies, for possible increase in service levels that will be provided by state and local governments to their citizens.

Allowing for even such very large increases in service levels and in work loads, it is still the case that rather modest increases in state and local tax rates in the aggregate are adequate to meet any deficit that is forecast between revenues at current tax rates and expenditures as projected.

If one allows for the federalization of certain functions, most notably welfare, as suggested by Professor Thurow, or of other functions as well, that pretty largely removes any aggregate deficit of state and local governments taken collectively. I refer you to "Setting National Priorities: The 1972 Budget," by Charles Schultz and others, published by my employer. (Laughter) I had to get that in sometime in the course of my remarks.

The second remark I wanted to make was that I'm willing to entertain the possibility that using poverty in a distribution formula may reduce the total amount of funds going to urban areas. But that's a pretty tricky term. "Urban areas," for example, include Washington, D.C. and all its environs, like Bethesda and Chevy Chase and Alexandria, which happen to be rather wealthy. It includes Chicago, but it also includes Forest Park and Glencoe. It includes Los Angeles, but it also includes Beverly Hills. In includes New York, but it also includes Scarsdale. It is not the case that including poverty in a formula of aid to local governments will reduce aid to New York City, to Washington, D.C., to Chicago, to Cleveland, to Los Angeles. It is emphatically the case that it will virtually cut off Scarsdale, Forest Park, Bethesda, and Beverly Hills. It seems to me anybody who wishes to defend federal aid to those suburbs has a heavy, heavy burden to bear. (Applause)

PROFESSOR THUROW: Since I've been accused of completely federalizing the world, let me tell you that I don't believe in that at all. I think we have to think very carefully when we use the term "fiscal mismatch." What does it mean? Well, it doesn't mean very much to me. It may mean something at the state and local level. A state may say to local governments, "There are certain taxes which you cannot use." The State of Massachusetts has said to Boston, "You must use the property tax. You cannot levy a sales tax. You cannot levy an income tax." Here, there is a fiscal mismatch.

Between the federal government and the state government there is no such fiscal mismatch. The state government is perfectly capable of levying any taxes it chooses. It can adopt the federal income tax structure, if it likes the federal income tax. There is no mismatch. All there is is a group of people who don't want to take the blame for levying the federal income tax in their own state.

I ask you to take the example that happened in New England recently. The State of Connecticut passed an income tax, had a political explosion, and canceled their income tax, and put on a lot of regressive sales taxes to generate the revenue they needed.

Now, the federal government did not say, "Thou must not use the income tax." It was the people in the State of Connecticut who, as you know, in terms of any tax effort index are at the bottom of the heap. Why should I help solve the mismatch of the State of Connecticut when the mismatch of the State of Connecticut is simply that the people of the State of Connecticut don't want to pay income taxes, which I pay in Massachusetts. I see no need. So I simply reject the mismatch theory.

When I say we need to think creatively about redistributing functions as an alternative to revenue sharing, I'm assuming that in most cases state governments are perfectly competent to pay for most of the functions they now do.

MR. SHANNON: I would like to make two comments. First, on the last observation, that the states are in essentially the same position with respect to levying taxes as the Federal Government — therefore no mismatch. I think there are two factors that *do* make a difference. One is the interstate tax competition factor. Time and again states have been played off one against the other. The fifty state "parts" do not possess the same tax strength as the Federal Union. There is this interstate tax factor that certainly is in the minds of many state legislators when they are calculating risks and it does hobble their tax policymaking.

Intensive use of the income tax by the National Government stands out as the second factor that has discouraged greater state use of this levy. This has been an inhibiting factor ever since 1937 or 1938 when Huey Long pushed the New Deal Administration into the "soak the rich" camp.

So these two factors, the interstate tax competition factor *and* the massive reliance of the central government on income but not on sales or property, I think, have skewed tax policymaking at the state level against income taxation. Therefore, some kind of an incentive is necessary to neutralize these disincentives and strike a better balance.

The second point, Why did the ACIR stop short? Why didn't we recommend that the Federal Government finance education lock, stock, and barrel just as we have for welfare. After all, both functions have externalities, spillover benefits, and so on and so forth.

I think that if you look at welfare and education more closely, however, you'll see there is a profound difference in these two functions. Welfare tends to be viewed as a boomerang function. The more a state does in this field, the more fearful its policymakers become that they will attract the poor from other states. In other words, virtue does not have its own reward. Thus in the welfare case you have to keep shoving financing responsibility upward to the highest level in order to get equitable distribution of benefits and burdens.

Now, what about education? Education is not in this category. Local and state policymakers look upon education as a merit good, and if a community develops a good reputation for schools, or if a state develops a good reputation for its schools and universities, this is a drawing card. This is something that stands the state in good stead.

Recently I noticed where Mississippi was advertising for industry. They didn't say a thing about low taxes, but they came down hard on education. "We're completely revamping our school system from kindergarten to graduate school." All right, when you have a function that is viewed in that light, it would be foolish to push the entire financing up to the top level. What you want the Federal Government to do is to serve in an equalizing and perhaps in some cases a stimulating role. But it would be a secondary or almost a tertiary financing influence. Sure, if you want to help the states improve the equity of their school aids you might have some Federal incentives, and so on. But the primary responsibility would be left at the state level because you know that the states will do the job of financing for you because it is in their self interest to do so.

So we've got to keep in mind that while both welfare and education are spillover functions, they are profoundly different in the eyes of lawmakers. You never hear of a state advertising, "We've got the highest welfare benefits." (Laughter and applause)

CHAIRMAN FITCH: I think this has been a first-rate set of papers, with which you might not all agree, even if the discussants don't agree among themselves, but it has been exceptionally stimulating.

MR. DRESCH: Can one still give comments then?

CHAIRMAN FITCH: You are almost too late, but . . . .

MR. DRESCH: I didn't know you were asking for them.

CHAIRMAN FITCH: I want to give a chance to the floor here but if you have a vital comment which can be made in the space of 35 seconds (laughter) I will yield to you.

MR. DRESCH: O.K., 35 seconds. On the question of schools, "Virtue is its own reward" doesn't help very much if you can't afford virtue. And I would submit that there are still substantial interstate differences in income. We haven't achieved any real regional equalization of income and that still is a major problem, not one that is secondary or tertiary.

On the redistribution pattern of the administration's general revenue sharing formula, equalization isn't a goal, we are told. Well, it happens that redistribution of income to some degree is a result of general revenue sharing, and it seems to me you can't ignore that result, even if that isn't a primary goal. Revenue sharing has to be judged not only on its ostensible objectives, which I think are probably not terribly well founded, but it also has to be judged on those consequences which may not be claimed for it but yet, nevertheless, would follow.

I ran over, sorry. (Applause)

MR. STRAUSS: May I respond?

CHAIRMAN FITCH: I did promise comments from the audience for the last ten minutes.

Would you please go to the mike and raise your question.

RAYMOND L. RICHMAN (University of Pittsburgh): I've found the discussion of the relation of revenue-sharing to the goals of stabilization and poverty to be interesting, as I have the discussion as to whether there is in the present proposals any net benefit to the cities, but I don't believe they are directly related to the problem of revenue-sharing. One of the things we discover when studying local government fiscal problems is that the basic mismatch is the difficulty that cities with large proportions of poor people have in financing an adequate level of services to them. There is of course also the fact that large proportions of poor increase the cost of police, fire and other services.

The defect in the original administration proposal relates to the weakness of the redistribution effects. Obviously the problem is to get the money to those communities that both need it and are willing to expend it to maintain a proper level of services. This can be done by incorporating a test of tax capacity *and* tax effort in the allocation formula.

With respect to Lester Thurow's suggestion for nationalization of functions, most of these functions will be performed and might as well be administered at the local level. This is true of garbage and waste collection and disposal, police, fire, streets, education, etc. The problem is not one of ability and willingness to perform these services, but one of financing these services to that portion of the population who lack the means to pay for them. It seems to me that Washington should finance services to poor people since it has a monopoly on progressive taxation. The suggestion made by some that states should finance these services, *e.g.*, education, means to rely on regressive taxation to finance what is essentially a redistribution problem.

CHAIRMAN FITCH: Is there anyone else who feels the spirit upon him? Then I will give an opportunity to Bob Strauss to reply to the preceding speaker and also to whatever else is on his mind.

MR. STRAUSS: As I expected before I got here, there has been controversy; there has been spirited discussion — and I suppose it is a good thing to have these differences aired.

My argument with you, Steve, is that if you have a series of goals for a particular expenditure program, it may turn out that they are not all consistent with one another, and if you want to make sure you achieve several of them, or one of them, you have to choose. What I mentioned to you just briefly before was that we have decided that fiscal relief is our primary objective. I think on that basis we do pretty well.

With regard to the actual distributional pattern within a state, I think it is fair to say that the per capita distribution, central city versus suburb, by and large favors the central cities. There are occasional suburbs that raise more revenue per capita, more general purpose local revenues than the nearby central city, and therefore they do get more general revenue sharing funds. But if you look at the population of these communities, I think you have to wind up saying that they represent a very small percentage of the population in the state, and that overall the formula works very well.

One of the impediments to employing any income measure in a local distribution formula is that the data is very difficult to get hold of. Those of you who have worked in regional economics know that local data on income or poverty are very difficult to get hold of.

I should like to say, in conclusion, that the Administration has always been open to suggestions for change in either the state or the local formula, but the changes that have been proposed to us so far have proven to be, upon examination, inferior to the proposed legislation.

CHAIRMAN FITCH: We have two minutes.

DR. DRESCH: Do I have time for a rejoinder?

CHAIRMAN FITCH: Well, I have two applicants. I will allot one minute to each. At twelve o'clock promptly we will turn back into a pumpkin and the meeting will be squashed.

DR. DRESCH: Mr. Strauss has suggested that I don't give proper weight to the administration's goal of fiscal relief. Now that may be true. We may be applying different weights here.

In the first place, I'm not sure we can agree that revenue sharing really represents fiscal relief. I think it may represent the reverse in a cyclical sense, to just add the cyclical concept. Fiscal relief is inverted. But fiscal relief is only *one* consequence of revenue sharing. There are other consequences, and you do have to place weights on these. It is fairly clear to me that even Mr. Strauss would not advocate revenue sharing, assuming that it *does* achieve fiscal relief, if it costs the entire welfare of the American people. There are limits beyond which one is not going to sacrifice to achieve just relief. You can't look only at fiscal relief and say, "Well, we achieved that, so we'll ignore these other consequences."

In a period in which there *are* alternative uses for federal funds, when you do have the family assistance plan being deferred, it seems to me *criminal* to take $5 billion and just scatter it out with no obvious benefit.

PROFESSOR THUROW: I would like to make a comment about leaving education to the states and localities. I would be all for that except for a recent analysis of the impact of the education funds that the federal government has been providing. These funds were to be used to help poor children get compensatory education. Yet the analysis indicates the states and localities took those funds and used them on the children they were not supposed to use them on.

Remember, the goal is not treating the localities equally or states equally; it is individuals equally or fairly. I don't care whether the

City of Chicago is treated fairly as long as everybody in Chicago is treated fairly. With very few exceptions, states and cities took education money and didn't spend it on those who they were supposed to spend it on. For all practical purposes, that education money has been an untied block grant. They spent it on education and they raised the general level of education but they didn't meet the federal objective.

CHAIRMAN FITCH: Now the hour has struck and we will all adjourn for lunch. (Applause)