Revenue Sharing— A Critical View

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The current discussion of revenue sharing reflects a wholesome shift away from preoccupation with Federal finances and toward a more comprehensive view of our fiscal structure, Federal, state, and local. Attention is focused, and rightly so, on current issues that call for immediate solution.

The fiscal plight of the cities and the need for expanded social programs are the crux of the problem. But the debate also poses the broader question of how a sensible fiscal structure of Federalism would be arranged and what kind of solution one should be striving for in the longer run.

I. Principles of Fiscal Federalism

To sketch this background, we begin by setting forth very briefly what the ground rules for fiscal Federalism should be. For brevity's sake and at the risk of sounding dogmatic, these will be summarized in five basic principles:

1. *The principle of diversity:* The Federal system should leave scope for variety and differences in fiscal arrangements pertaining to various states and localities. Communities may differ in their preferences for public services and should not be forced into a uniform pattern. Let the flowers bloom.

2. *The principle of equivalence:* Cognizance must be taken of the fact that the spatial scope of various public services differs. The benefits of some are nationwide, such as defense; those of others

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are region-wide, such as roads and flood control; and those of still others are local, such as city police or street lights. Similarly, the burden incidence of some taxes can be confined to a particular area more readily than that of others. For fiscal arrangements to be truly efficient each type of service would be voted on and paid for by the residents of the area which benefits.

3. *The principle of centralized redistribution:* The redistributive function of fiscal policy (i.e., progressive taxation and transfers) should be centralized at the Federal level. Otherwise, redistribution becomes ineffective and location decisions are distorted.

4. *The principle of locational neutrality:* Regional fiscal differences tend to interfere with the location of economic activity. Some degree of interference is an inevitable cost of fiscal Federalism, but it should be minimized. Differential taxes which (in the absence of offsetting differential benefits) distort location decisions should be avoided.

5. *The principle of centralized stabilization:* The use of the fiscal instrument for purposes of macro (stabilization, growth) policy has to be at the national level. State treasuries, like regional Federal Reserve Banks, cannot make stabilization policy on their own.

These principles are more easily stated than applied. In the real world fiscal institutions are the result of historical forces and imperfect in many respects. Various public services are not readily classified by their spatial incidence; existing jurisdictions frequently do not correspond to benefit areas, spill-overs occur, and more suitable jurisdictions are difficult to create; in other cases, jurisdictions are saddled with the spill-in of national burdens which are not of their making; the cost of taxes used to finance local benefits may be shifted to nonresidents; state and local finances do not operate in a setting where adequate distributional adjustments have been made at the Federal level, and so forth. For these and other reasons the design of fiscal Federalism should allow for three supplementary criteria:

6. *Correction for Spill-overs:* Benefit spill-overs between jurisdictions lead to inefficient expenditure decisions. This calls for correction by higher levels of government.

7. *Minimum Provision for Essential Public Services:* The national government should assure that each citizen, no matter in which

state or locality he resides, is provided with a minimum level of certain essential public services, such as safety, health, welfare, and schooling.

8. *Equalization of Fiscal Position:* While redistribution is primarily an inter-individual matter, the existence of sharp regional differences in the balance between fiscal capacity and need among governments cannot be disregarded entirely. Some degree of fiscal equalization among governments is called for so that minimum service levels can be secured with more or less comparable tax efforts.

Not all these points are of equal importance for this discussion, and the last two are more controversial than the others. However, we shall find them to be necessary conditions of a sound fiscal Federalism in the current U.S. setting, and essential to a solution of our fiscal crisis.

II. Fiscal Needs and Resources

With these considerations in mind, we now turn to the role of revenue sharing, first proposed by Walter Heller in 1964. At that time, economists were concerned with countering a slackening economy and averting the repetition of stagnation by "fiscal drag," such as had occurred in the late fifties. The outlook was for a steadily rising Federal full-employment surplus and widespread fiscal deficiencies at the state-local level.

In this setting, the transfer of Federal revenue to the states and localities would avoid repetition of fiscal drag and do so better than tax reduction. At the same time, it would serve to finance a wide range of state and local needs and do so with a tax structure superior to that at the state-local level. To expedite enactment and minimize opposition, the plan was proposed in the simplest possible form, i.e., distribution to the states on a population basis, without strings and pass-through provisions.

This is also said to have been the spirit of the Johnson task force report under the chairmanship of Joseph Pechman. Since then much has happened. The scene, initially so conducive to revenue sharing, has undergone substantial change.

Federal Outlook

It is now apparent that the silver lining on the fiscal horizon has

been tardy in developing. The magic formula of "$15 billion annual built-in revenue gain minus $10 billion annual expenditure increase (present programs) equals a $25 billion dividend in five years, which, after adding a $20 billion one-shot reduction in defense, gives a $45 billion surplus five years from now" has refused to materialize.

The revenue response has been slowed down by premature (current and postdated) tax reduction, the hoped-for decline in defense spending has been slight, and increases in other programs (including the Great Society programs of the Johnson Administration and the proposed plans of the Nixon Administration) have outweighed the reductions that did occur. The immediate prospects are for deficit rather than surplus, and the current discussion is in terms of finding new revenue rather than of disposing of surplus. Most important, it now appears that a fiscal dividend in the $40 to $50 billion range is unlikely to materialize even over the next five years or more.

Recent estimates by Charles Schultze visualize a potential full-employment surplus of $23 billion for 1975.[1] This figure allows for the effects of the Tax Reform Act of 1969, for built-in increases in present programs, as well as for the Administration's welfare and revenue sharing plans. Vietnam expenditures are assumed to have fallen to $1 billion and defense expenditures are reduced (in real terms) by $9 billion below 1971 levels.

Schultze further holds that a budget surplus of $10 billion will be needed if the Administration's housing goals are to be implemented in a noninflationary fashion. His free dividend is thus reduced to $13 billion, or $18 billion prior to the Administration's revenue sharing program.

While it is difficult to predict the need for surplus five years from now and while we would be unwilling to place general (as against low-cost) housing expansion ahead of social programs, it is evident from these estimates that the Federal budget outlook is not one of unlimited slack. Not only will the budget remain tight over the next couple of years, but even by 1975 the magnitude of potential slack will be substantially less than had been expected.

State-Local Outlook

At the state-local level we also note some change from the earlier

[1] For reference, see Table 1.

TABLE I

FISCAL OUTLOOK AND VERTICAL IMBALANCE

(Fiscal years and billions of dollars)

		1971	1975
FEDERAL			
Revenue			
1.	Employment Taxes	49.1	68.8
2.	Other Taxes, etc.	153.0	207.2
3.	Total, budget revenue	202.1	276.0
Expenditures			
4.	Defense	73.6	75.0
5.	Grants-in-aid	24.8	33.0
6.	Other	102.4	140.0
7.	Total, budget expenditures	200.8	248.0
8.	Balance, expenditure account	1.3	28.0
STATE AND LOCAL[1]		**1967**	**1975**
Revenue			
9.	Own Revenue	76.4	141.2
10.	Federal Grants	15.5	33.0
11	Total	91.9	174.2
Expenditures			
12.	Total	96.8	191.4
13.	Balance	-4.7	-17.2
14.	Net Borrowing	4.7	10.7
15.	Deficiency[2]		6.5
16.	GNP	985	1,428

Lines 1–8: From C. L. Schultze, *Setting National Priorities, The 1971 Budget,* The Brookings Institution, 1970.

Lines 9–15: See W. H. Robinson, "Financing State and Local Government: the Outlook for 1975," Table 9. Profits on liquor stores is included in (9). Additional employee retirement and deficit in utility operations are included in (12). (13) equals net borrowing minus addition to liquid assets.

For revenue data see p. 181. For 1971 expenditures, see p. 12. For 1975 expenditures total see p. 186. Schultze's figure of $253 billion is reduced by $5 billion to exclude revenue sharing. For figures on national defense in 1975 see p. 184. The grant-in-aid figure for 1975 is taken from line (10) increased by $5 billion for revenue sharing and line (6) is residual.

Line 16: The figure for 1975 from Schultze, *op. cit.*, p. 180. Rate of price increase is assumed to taper off from 4½ percent in 1970 to 2¼ percent in 1975. Unemployment is assumed at 3.5 percent after 1973. The 1975 GNP underlying lines 9–13 (see Robinson, *op. cit.*) is assumed at $1,340 billion.

setting. Whereas the estimates of a few years ago projected a rapidly rising level of deficits, more recent approaches give a less alarming picture. W. H. Robinson estimates that in 1975 state and local expenditures will be at $191 billion after allowing for increased work load due to rising population and for quality improvement at past rates.[2] Revenue, including Federal aid expanding at normal rates, is estimated at $174 billion, leaving a deficit of $17 billion.

Of this, $11 billion will be covered by normal borrowing, leaving a gap of $6 billion. This is only slightly above what the Administration's revenue sharing program would add annually by 1975. Alternatively, it could be met by a 5 percent increase in tax rates at the state-local level, an increase which seems well within the reach of state-local governments, given their past record of rate increases.

Vertical Imbalance and New Programs

Putting the two sides together, one appears to arrive at a fairly complacent conclusion. While the prospective Federal excess will not be as substantial as had been expected, neither will be the deficiency at the state-local level. This conclusion, however, is misleading in two respects.

A first flaw is that these estimates do not allow for major new programs which will become part of the public agenda. While a start has been made under the Johnson and Nixon administrations, this is surely just a beginning. The Administration's welfare plan is a qualitative improvement but amounts to very little in magnitude. There clearly remains the need for a major move towards an income maintenance plan, be it through a negative income tax or in some other form. Urban reconstruction, improved primary and secondary education for the disadvantaged, low-cost housing, and anti-pollution measures are other items. The cost of these programs can (and should) easily reach the prospective excess of Federal revenue by 1975. The dividend dollars, if and when they materialize, will not be lacking of claimants. Rather, the problem will be one of using scarce dollars in the most efficient fashion.

In place of the 1964 outlook for a large and freely available Federal dividend, combined with a widespread deficiency at the state-local level, we now find (1) that only a limited Federal surplus is in sight, (2) that state-local resources will keep approximately (though not quite) in step with rising costs of existing programs, and

[2] For reference, see Table 1.

(3) that substantial new programs — in particular, programs oriented toward poverty and disadvantaged groups — will be called for.

It follows that the bulk of the potential revenue slack will be needed to finance these social programs. If one accepts these priorities, the case for revenue sharing at this time depends on what it contributes to meeting them. This is to say, it depends on whether responsibility for these programs can be centered at the state-local level; and if so, whether *generalized* sharing will produce the proper distribution of funds.

The answer is no on both counts. Any major expansion of income maintenance must be uniform on a nationwide basis. This follows from the principles of equivalence and centralized redistribution. It is clearly a Federal function and has to be performed at that level. Such a program implemented at an adequate scale will cost at least $10-15 billion. It alone might well absorb the available slack in the Federal budget, not to speak of other urgent programs such as rehabilitation of urban slums.

Given our premise that concern with poverty should receive top priority, these programs outrank generalized revenue sharing. The basic hypothesis of generalized vertical imbalance — Federal excess with state and local deficiency — is invalid. On the contrary, we are fortunate in that the excess revenue will accrue where it will be most needed, that is, at the Federal level.

But though there may be no generalized vertical imbalance, it does not follow that there exists a happy coincidence of revenue sources and needs throughout the system. Taking too aggregative a view is misleading. Though there may be no major imbalances (in terms of these estimates) for state and local governments as a whole, this does not exclude a mismatching of resources and needs among states or areas within states. Far from it. The gross deficit (total deficit of deficit units) is substantially larger than the net deficit of $6 billion (which includes the surplus of surplus units). The system is riddled with instances of regional imbalance, to some degree on an interstate basis, but primarily among areas within states. This is brought out most strikingly in the fiscal dilemma of the older cities although it is by no means only an urban phenomenon.

It is this horizontal imbalance which is the real trouble and toward which the potential surplus must be directed. Moreover, this imbalance is linked to the burden of present social expenditures and

to the new social programs that are needed. As we shall see presently, solving the one will also go far in solving the other.

III. Instruments of Inter-governmental Transfer

Before proceeding with this point, let us pause to compare the merits of alternative techniques of matching needs and resources. Revenue sharing, categorical grants, transfer of expenditure functions, tax credits all present possible approaches. What are their characteristics and how well are they suited to meet the present situation?

Similarities

To begin with, there are similarities as well as differences. In particular, there is no sharp distinction between revenue sharing and grants. Revenue sharing, after all, involves the making of grants, and grants involve the sharing of revenue. Revenue sharing with a population-based formula is similar to a population-based grant. Revenue sharing without strings is equivalent to block grants, while sharing with strings is equivalent to categorical grants. Addition of an effort element into the sharing formula is similar to adding a matching requirement and so forth.

Both the Administration and ACIR (S.2483) plans provide for a population-based block grant with a slight matching (or revenue effort) requirement. The Javits plan gives 85 percent of the cost to this type of grant, but distributes the remainder among the lower income states in inverse relation to per capita income.

But though there is a formal equivalence between grants and revenue sharing, there is an important difference in emphasis between the two. The sharing approach is typically viewed in terms of unconditional block grants (without strings) and only a modest equalization effect, while the grant-in-aid approach is traditionally viewed in terms of categorical and matching grants with considerable emphasis on equalization. The basic questions, therefore, are (1) should the transfers be general or categorical, (2) should they be nonmatching or matching, and (3) should they be heavily equalizing or not?

Block versus Categorical Transfers

There is a strong case for the block (no strings) approach, inherent in general revenue sharing, if the purpose of revenue transfer is merely the substitution of Federal for state-local taxes. In this case

there is no reason for interfering with the use of the funds. Substitution of Federal taxes is a worthwhile objective in itself. Federal taxes – the progressive income tax in particular – are superior. They are more equitable, more easily administered, and locationally neutral. But improving the composition of the tax structure is not enough, nor can it be given top priority at this time. The priorities are on the expenditure side and the question is whether they will be better served with or without Federal strings.

The argument in support of the block (no strings attached) approach is that state and local governments are closer to the people and know better what they want. This is our principle of diversity. The opposing case, stated in our principle of equivalence, is that the national government has primary concern with services whose benefits are nationwide in scope. Moreover, it may wish to assure minimum levels of selected services which are considered most essential and treated as "merit goods." At the same time this does *not* justify an across-the-board support of *all* public services at the state and local level. Unconditional Federal financing of local public services is difficult to reconcile with the principles of fiscal Federalism. It conflicts with the principle of equivalence and meets neither the equalization nor the minimum-standard criteria.

This objection does not apply to categorical grants which deal with services of national importance (correction for spill-overs) or set specific minimum standards. This has been the traditional intent of categorical grants, and on the whole these grants have worked well. While there is some reason for complaint about excessive proliferation of such grants, this does not invalidate a sensible use of the categorical approach.

A desirable compromise might be to consolidate the existing 400 plus grants into a smaller number covering broader categories, and to provide a mechanism by which such programs can be subject to periodic review, as has recently been proposed by ACIR. While a good deal can be done to improve the present system, the categorical approach is basically sound and should be retained at least over the area to which it now applies. This appears to be accepted by most parties to the debate. The Heller-Pechman plan, in particular, makes it clear that the proposed revenue sharing is to be supplementary to, not in lieu of, existing categorical grants.

At the same time, as far as new outlays are concerned, revenue sharing competes with expanded categorical grants or direct federal

programs. If there is to be revenue sharing, the same arguments which support categorical grants also suggest that some strings be attached, both with regard to assigning the funds to broad service areas (those most essential from the national point of view) and to maintaining minimum standards. The objection to earmarking along broad expenditure categories is that it may be easily evaded. If transfers or grants are earmarked for purpose A, the receiving government can always direct its own resources towards area B. This difficulty exists, but it is not insuperable, especially if coordinated with consolidation of existing specific grant programs into larger units.

Apart from earmarking provisions, legislation to make new funds available may also be used to encourage other improvements in state-local performance, such as consolidation of governmental units called for in the Reuss bill,[3] or the adoption of performance standards for certain programs.

Outright versus Matching Grants

Moreover, the difficulty of sidestepping grant objectives goes farther and points to a serious shortcoming of any outright (as against matching) grant approach. Just as earmarked grants may be diverted to other uses, so may outright grants be diverted into state-local tax reduction (or omission of increase) rather than provide more adequate expenditure programs. The grant is then equivalent to a transfer to those individuals whose taxes are reduced. There is no objection to this as long as the result is merely substitution of superior Federal for less desirable state-local taxes. But it is not sufficient if the transfer is also designed to secure higher expenditure levels. For this objective, matching type grants are clearly more efficient. They reduce the own-cost of public services and exert a substitution effect which the outright grant fails to provide.

As noted before, the inclusion of a tax effort component into the revenue sharing formula (all the major proposals contain an effort component) does in effect act as a matching provision. If the grant received by any one state depends on the product of its population

[3]See "Revenue Sharing as a Means of Encouraging State and Local Government Reform" by Representative Henry S. Reuss in *Revenue Sharing and its Alternatives: What Future for Fiscal Federalism?,* Joint Economic Committee, 90th Congress, July 1967, Volume 2, page 977. The latest version of this plan is H.R. 11764, "The State and Local Government Modernization Act of 1969," introduced on May 28, 1969.

and tax effort (ratio of tax revenue to personal income) relative to that for all states as a whole, then any one state (acting by itself) may increase its grant by increasing its tax effort. Taking the Administration's plan, this works out for Massachusetts as 7 cents per additional dollar of tax revenue, i.e., a matching rate of 7 percent.[4] By the nature of the formula, the matching rate works out somewhat higher for poorer states, but it remains at a generally low level.

While the effort component is not an adequate substitute for a matching provision, it does serve a useful purpose on other grounds. If the equalization criterion is applied, the donor states (i.e., those that are fortunate enough to be fiscally strong) are entitled to assurance that the donee states (i.e., the less fortunate states which are fiscally weak) make an adequate effort of their own. They can be more readily expected to help those who help themselves, than to support free riders. The effort component should thus be in the formula, but it is not an adequate substitute for matching.

Tax Credits

While tax credits bear some similarity to the revenue sharing and grant approaches, there are also important differences. Suppose that income taxes at both Federal and state levels are proportional, that

[4]The formula under the Administration proposal is

$$G_j = B \frac{\frac{N_j R_j}{Y_j}}{\sum \frac{N_i R_i}{Y_i}}$$

where G_j is the grant to state j, B is the total amount distributed, N_j is population in the state j, Y_j is personal income in state j, and R_j is state and local tax revenue in state j. Setting B = \$5 billion; N_j for Massachusetts = 5.4 million; Y_j = \$18.9 billion; and R_j = 2.0 billion. Using figures for 1967, the aggregated term in the denominator equals 19763.47, and we obtain

$$\frac{dG_j}{dR_j} = .0722.$$

For a similar computation, see Charles J. Goetz, "Federal Block Grants and the Reactivity Problem," *The Southern Economic Journal*, July 1967.

the entire revenue of states comes from the income tax, and that the Federal credit for state taxes is paid to the state treasury rather than to the taxpayer. Given these conditions, a 50 percent Federal credit would be equivalent to a 50 percent matching grant.

Actually, these conditions are not met. Since the credit is given to the taxpayer rather than to the state treasury, the latter may not be able to recoup and to raise its taxes accordingly. In this case, the credit becomes a Federal grant to individuals. But even if it were to go to the state treasury, the credit approach differs in two respects. Since the states use a variety of taxes other than the income tax, the credit device – being in the nature of categorical revenue matching – may be used to improve the composition of the state-local tax structure.

As a device for tax structure improvement, it thus ranks ahead of grants or general revenue sharing.[5] But against this advantage, the credit has the disadvantage that it does not permit application of the equalization criterion. Federal support is necessarily related to the own revenue of the locality. Since the equalization aspect turns out to be of central importance, we do not assign a major role to the credit approach.

Transferring Expenditure Functions

The final technique is that of transferring expenditure responsibilities rather than revenues. This would be a weak candidate if the revenue deficiency at the state and local level were general, and all state-local programs were equally important to the nation. But neither condition holds. Rather, the incidence of fiscal imbalance is uneven. National priorities apply, and the two problems are not unrelated. The transfer of some expenditure functions (or the financing thereof at the Federal level) thus becomes a major contender.

IV. Horizontal Imbalance and Equalization

This brings us to the crux of the problem, i.e., the existence of horizontal imbalance on the one side and the need for more adequate

[5]Substitution of a credit for the present deduction would redirect the grant from higher towards lower income recipients. Under a recent C.E.D. proposal, a credit is added to the deduction, but the credit is limited to a given percent of the *net* cost imposed by the state tax, allowing for reduction in Federal tax due to deduction of state tax. See *A Fiscal Program for Balanced Federalism,* Committee for Economic Development, June 1967, Appendix V.

social programs in dealing with poverty on the other. While the problem of distribution is primarily one of distribution among individuals (not governments), the issue of "poor governments" exists as well; and it does precisely because the state of distribution among individuals is unsatisfactory. How are these two key problems related, and how can they be met at the same time?

Interstate Differentials

To measure imbalance among states (using the term to include state and local functions within states), it is necessary to design measures of fiscal capacity and need. Capacity is measured in terms of the per capita yield of a representative state-local tax system. Need as here defined is measured as the cost of supplying average performance levels for the existing mix of state-local programs.[6]

Measurement is possible, without too much difficulty, on the capacity side. Using income as a rough guide, we find per capita income of the lowest state to be about one half that of the highest. Better indicators of fiscal capacity may be obtained by applying a model tax system to the various states. Here we find an even wider spread, with per capita capacity at the top of the scale nearly three times that at the bottom.[7]

Determination of need (or better: of relative expenditure levels required to provide equal service levels) is a much more difficult proposition. Per capita expenditures are readily available and differ widely, although not as much as fiscal capacities. Federal transfers are an equalizing factor, as is a tendency for states with low capacities to exert a greater effort. The important point, however, is that relative expenditure levels do not measure relative need.

The cost of providing similar service levels differs due to both differences in factor prices and in the inputs required to achieve similar outputs (road maintenance in Florida calls for lower inputs per mile than in Vermont). Also, different communities vary in their preferences and choose to furnish (or are capable of furnishing) different service levels. Relative needs, therefore, cannot be deduced from expenditures. They are difficult to measure, for both concep-

[6]For a further discussion of needs, see Appendix, p. 1.

[7]See *Measures of State and Local Fiscal Capacity and Tax Effort* (October, 1962), Table 13, Advisory Commission on Intergovernmental Fiscal Relations.

tual and statistical reasons.[8]

Yet, a measure of relative capacities and needs and of capacity-need differentials is required to determine what pattern of equalization is called for. More information is required than rough generalizations, such as that per capita distribution favors the Eastern seaboard states, while distribution with allowance for average income favors the South. In the absence of a comprehensive study of needs, leading to a composite needs index, we attempted to take a stab at the problem.

Using 1960 data, we endeavored to compute an index of fiscal position, showing the differential between capacity and need for each state, standardized such that the sum of excess needs (in excess-need states) equals the sum of excess capacities (in excess-capacity states). We then raised the level of need by $5, $10, and $20 billion respectively by proportionately increasing the levels of existing needs. Finally, we applied a number of revenue sharing plans of corresponding magnitudes but with different distribution patterns. The efficiency of these plans was then measured in terms of the resulting percentage reduction in excess needs.

The assumptions and procedures of the study are explained in the Appendix. While the underlying analysis is quite rough (a careful study of this sort would involve a major research effort), the results are nevertheless interesting and are suggestive of the kind of study that is needed. The major conclusions regarding the existing imbalance among states, as shown in Table 3 of the Appendix, are as follows:

1. Twenty-one out of 51 states have an excess of need over capacity. The size of the deficiency relative to expenditure needs is largest, ranging from 40 to 70 percent (after allowing for Federal transfers), in the Southern low-income states. The size of the gap in other deficiency states is much less. Deficiencies are explained primarily by below-average capacities, but above-average needs also contribute to the result.

2. Twenty-nine states, including the high-income states, show an excess of capacity over need. The level of excess relative to

[8]Many of the difficult problems in this area have been attacked by Dr. Selma J. Mushkin, as Director of the State and Local Finances Project. She and her colleagues have examined in detail the more important state and local activities in an effort to project future expenditures. This work was published by the Council of State Governments in 1965 and 1966 as Research Memoranda 374-5, 379-382, 384, 389-90. No attempt was made, however, to compute a composite index of fiscal position based on these studies.

expenditure needs runs up to 48 percent, but on the whole these ratios are less extreme than for deficiency states. By our measure, the occurrence of excess is primarily due to above-average capacity.

3. If we exclude the dozen or so lowest income states, the size of the gap (positive or negative) is mostly modest relative to needs. Outside this group, the gap (positive or negative) exceeds 20 percent of expenditure needs in only four states.

While this result may be biased by inadequate accounting for need differentials, it nevertheless suggests that the problem of imbalance (with the exception of the low-income Southern states) is not primarily an interstate problem.

The results obtained from the application of various transfer plans are shown in Table 2, parts (a) and (b). Nine distribution patterns are compared, and they differ substantially in their performance. Our measure of performance in part (a), as noted before, is the percent of the fiscal gaps (i.e. excess of need over capacity) which are removed by the various plans. The Table also shows, in part (b), the percent of the program cost going to close these gaps rather than as payments to states with excess capacity. The results under each program are computed on a base which excludes present Federal transfer programs (columns 1 to 3) and on a base which includes such transfers (columns 4 to 6). The results indicate that:

4. At any given budget level, distribution by potential welfare recipients consistently did the best. A plan based on a combination of welfare recipients and school-age population was the next most efficient. A per capita distribution plan or the Administration Program did less well, while the Javits plan fell in between the Administration and welfare plans.

At the $5 billion program level, for instance, (including federal transfers in the base) we find that the plan based on potential welfare recipients closes 50.3 percent of the gaps while the Administration plan closes 41.5 percent and the per capita plan closes 42.6 percent. The Javits plan, at 44.2 percent, falls in between. Stated differently, under the potential welfare recipient based plan, 65.4 percent of payments, or $3.3 billion, goes into gap closing as against 52.4 percent, or $2.6 billion,

TABLE 2

MEASURES OF PROGRAM EFFICIENCY

(a)

Percent of Deficiencies (Excess of Need Over Capacity) Removed*

Program	Without Federal Transfers			With Federal Transfers		
	$5 Billion Program	$10 Billion Program	$20 Billion Program	$5 Billion Program	$10 Billion Program	$20 Billion Program
Revenue Sharing Per Capita Plan	38.6	59.4	77.5	42.6	63.6	79.9
Revenue Sharing Administration Plan	37.7	58.1	75.9	41.5	62.2	78.1
Revenue Sharing Javits Plan	41.2	62.1	79.3	44.2	64.9	80.0
Welfare Assistance Proportional to Potential Recipients Plan	47.1	69.6	85.6	50.3	71.6	84.5
Welfare Assistance Proportional to Own Welfare Expenditures Plan	31.6	49.8	65.7	35.2	54.1	67.7
School Assistance Proportional to School-Age Population Plan	39.6	60.6	78.7	43.6	64.8	81.1
School Assistance Proportional to Own School Expenditures Plan	34.2	53.5	70.9	38.2	58.0	73.6
Negative Income Tax Plan	4.4	8.8	13.8	5.7	9.4	13.9
Combination Weighted Welfare and School Assistance Plan	41.6	63.2	81.4	45.3	66.9	83.4

*For explanation see Appendix.

TABLE 2 CONTINUED

(b)

Percent of Program Funds Used to Remove Deficiencies

Program	Without Federal Transfers			With Federal Transfers		
	$5 Billion Program	$10 Billion Program	$20 Billion Program	$5 Billion Program	$10 Billion Program	$20 Billion Program
Revenue Sharing Per Capita Plan	53.7	63.7	77.6	56.7	68.1	80.3
Revenue Sharing Administration Plan	52.4	62.3	76.0	55.3	66.6	78.5
Revenue Sharing Javits Plan	57.2	66.6	79.4	58.9	69.5	80.4
Welfare Assistance Proportional to Potential Recipients Plan	65.4	74.6	85.8	67.0	76.6	84.9
Welfare Assistance Proportional to Own Welfare Expenditures Plan	43.9	53.4	65.8	46.9	57.9	68.0
School Assistance Proportional to School-Age Population Plan	55.1	65.0	78.8	58.1	69.4	81.5
School Assistance Proportional to Own School Expenditures Plan	47.1	57.3	71.0	50.9	62.1	73.9
Negative Income Tax Plan	6.1	9.4	13.8	7.6	10.1	14.0
Combination Weighted Welfare and School Assistance Plan	57.8	67.7	81.6	60.3	71.6	83.8

under the Administration plan. The corresponding amounts of slippage are $1.7 and $2.4 billion.[9]

5. The relative efficiency of the various plans narrows as the budget increases, with the absolute differences in efficiency showing little change.

6. The results are essentially the same, whether present Federal transfers are or are not included in the base.

In all, it appears that the various distribution patterns differ significantly in their efficiency and that distribution by welfare and school population is to be preferred. This is an interesting finding because (1) such distributions also tend to be in line with meeting intrastate differentials and (2) welfare and school needs carry high national priority.

Intrastate Differentials

The next step in a careful analysis of the problem would be to apply similar techniques of measuring fiscal capacity and need to subregions within states. Such an analysis may be expected to show a higher differential than is yielded by comparison among states. The situation will be influenced substantially by the incidence of poverty with its bearing on both the capacity and the need side of the fiscal equation. Without going into detail, the following facts – some of which are rather contrary to the conventional assumptions – may be worth noting:

1. The poverty problem is by no means exclusively an urban problem. About 50 percent of the poor are outside metropolitan areas. Only 26 percent are in metropolitan areas of over one million; and only 17 percent are in the central cities of such areas. It is thus quite misleading to think of the large eastern cities as reflecting the poverty problem.[10]

[9] These are significant differences but the differential may well be understated due to our rather crude method of evaluation. Ideally one would want to weigh each dollar in relation to the relative size of the gap closed, and to weigh dollars given excess of the gap in relations to the degree of excess. Our cruder measure gives equal weights to gap-closing dollars and zero weights to all dollars which do not go towards closing gaps. We do not mean to suggest that money not used for closing gaps is entirely wasted.

[10] See *Trends in Social and Economic Conditions in Metropolitan Areas,* Special States, Series p-28, No. 27, February 7, 1969, U. S. Department of Commerce, Bureau of the Census, p. 53.

2. Within metropolitan areas the incidence of poverty is by no means only a core city phenomenon. About 60 percent of the poor are located in central cities, while 40 percent are located in the suburban rings.[11] However, core city costs are higher, so that these unadjusted data tend to understate the relative magnitude of the core city problem.

3. The incidence of nonurban poverty is typically in low-income states, while that of urban poverty is typically in high-income states.

4. The metropolitan areas which suffer most acute fiscal distress are not only in relatively high income states but are also characterized by relatively high average incomes compared to other SMSA's. Thus, out of 216 SMSA's (1967 data) only 34 had per capita income above $3,400. Yet all but two of the twelve largest SMSA's belonged to this group, including (with the exception of Baltimore) all the large eastern seaboard cities.[12]

5. With the exception of New York the tax effort of these high-income SMSA's is not above the average for all SMSA's.[13]

The conclusion to be drawn from these facts is that revenue sharing modified by an income-type capacity variable would do little to solve the problem. Not even income equalizing distribution to SMSA's would serve the purpose. Fiscal differentials in these instances primarily result from the need rather than the capacity side. The only major exception of association of need and generally low capacity is in the low-income states. This is recognized to some extent in the Javits plan, where 15 percent of the total disbursement is allotted to low-income states. This minor part of the plan may well be its most useful component.

As to the other part of the problem – poverty in the SMSA's – the question arises whether, given the relatively high income levels of these SMSA's, the residents should not be called upon to put their "own" house in order and to take care of their "own" problems.

[11] *Ibid.*

[12] See *State and Local Finances, Significant Features, 1967 to 1970,* ACIR, Washington, November 1969, Table 2, pp. 13-20.

[13] *Ibid.*

This would require governmental units corresponding to SMSA's. But suppose that such units could be set up. Even then, this would not be the proper solution. To be sure, it is altogether proper to ask the suburbanites to help defray the cost of city services which they consume. But it does not follow that they should be called upon to pay for the welfare and social-service costs which arise from the concentration of low-income families in the city core. This responsibility should be carried by those who are more fortunate regardless of where they live. This being the case, the proper solution is the assumption of such costs on a nationwide basis, financed by progressive income taxation.

If per capita income in Westchester is high, Westchester residents should contribute more to the national finance of such services than the residents of Harlem; but so should wealthy residents of Arizona or Honolulu. The fact that Westchester is close to New York City, we repeat, is good reason for calling upon Westchester residents to contribute to commuter and other city facilities which they enjoy, but it should not be a reason for paying a disproportionate share of the city's welfare costs. These costs are a "spill-in" which result from national problems and that is where the cost should lie.

The question remains how national financing of such costs is to be accomplished. One way of doing so is to implement a fiscal system (a grant system, call it revenue sharing if you wish) where the distribution is from the Federal government to localities in line with their share in such national needs.

This, however, would require a complicated system of grants much more complex than is implied in a present expenditure-based pass-through provision, as provided for in the Administration plan. It would be revenue sharing in name only. Instead, the objective could be met more effectively and simply by Federal assumption of responsibility for the financing of the welfare system, initially at its present level and hopefully by way of an expanded income maintenance plan later on.

Beyond this, at least partial Federal finance of minimum levels of primary and secondary education is a desirable objective. These also are functions which in a highly mobile society have come to be of fundamental national importance and thus justify Federal financing. Taking the form of a minimum per student grant (with allowance for cost differentials), such a plan need interfere in no way with local responsibility for educational policy except, we would hope, for the

basic requirement of school integration. Given such a transfer of responsibility for welfare and at least part of primary and secondary education, the states and cities would then be in a position to take care of their remaining needs, out of their own fiscal resources and in line with their own preferences.

V. Conclusions

In closing, let us summarize the conclusions to which this analysis leads:

1. The combination of large Federal surplus with generalized across-the-board state-local deficiencies does not now exist and is not likely to materialize in the foreseeable future.

2. Instead, the problem is one of scarce Federal funds, matched by a highly complex pattern of deficiency at the state and local level.

3. Deficiency areas fall into two major parts:

   a. the low-income states in which relatively high general needs are combined with low capacity, and

   b. urban areas within high-income states, areas which have relatively high incomes but even higher national needs.

4. Problem (a) may be met in part by general transfers or revenue sharing limited to low-income states, e.g., the 15 percent part of the Javits plan carried out on a larger scale.

5. Problem (b) cannot be met by leaving the responsibility with the residents of the particular SMSA's. Nor can it be met adequately by capacity-related or per-capita-based generalized forms of revenue sharing. Rather it calls for the Federal government to assume full financial responsibility for welfare, first at present levels and later on at a substantially increased scale of income maintenance.

6. If and when a more substantial surplus in the Federal budget develops, the Federal government should then assume partial financial responsibility for minimum performance levels in the primary and secondary schools.

7. The existing system of categorical grants should be consolidated, but the basic principle of matching, specification of project area, and setting of general performance standards should be maintained.

Given such adjustments, the fiscal ills at the state-local level will be relieved and limited Federal funds will be used in a more effective fashion than under generalized revenue sharing. While such sharing is better than Federal tax reduction, it does not at this stage constitute the best or even second best use of funds.

Appendix

The following explains the analysis which underlies the results of Table 2.

A. State-Local Fiscal Needs, Capacities, and Gaps

Over the years, economists have become more and more adept at "explaining" (in terms of R^2) the variation of state and local per capita expenditures. Even if these regression models were "good" models (in a statistical sense), they would still lack the kind of information that is necessary for deciding how to distribute Federal funds most effectively.

Measuring Relative Needs

In understanding why, it will be useful to distinguish between the following concepts:

(1) observed per capita expenditure levels;
(2) output or service levels, measured in terms of performance units;
(3) inputs needed per levels of outputs, i.e., production functions;
(4) costs of inputs
(5) per capita expenditure needs to provide a given output or performance level.

It follows that for any state and public service, (5) is a function of (3) and (4). Also, it is evident that (1) may differ from (5), either because (3) and (4) differ or because the demand for public services (service levels demanded at various unit costs) differs.

A proper analysis of relative expenditure needs would involve two steps. Step I is to determine, for each type of service, the cost of various service levels for each state. Step II is to allocate expenditures for all states as a group among the various services and to allocate the sub-total for each service category among states so as to equalize

service levels. Expenditures thus distributed would reflect relative expenditure needs and add up to total expenditures.[1]

Assuming the total expenditure level to be given, the question is how it is to be allocated among categories? If we take existing allocations between highways, welfare, education etc., we implicitly use the system of weights as reflected in the prevailing pattern. This reflects not only state and local preferences but (via categorical grants) also Federal preferences and (via state grants) the imposition of state preferences on local budgets.

The actual procedure here followed is but a very first approximation to what should be done. Not only were the weights implicit in the existing (1960) expenditure distribution among categories accepted as given, but even a crude attempt was made to measure needs in two categories only.

Our measure of need is made up of three components: (1) a "welfare need" per welfare recipient; (2) a "school need" per student receiving school services; and (3) an "other need" per general population. The first need is computed by dividing (a) direct general expenditures for welfare by all state and local governments ($4.4 billion), by (b) the U.S. local school population (using persons under the age of 18 as a proxy). The third need is computed by dividing (a) total direct general expenditures by all state and local governments other than welfare and local schools ($32.3 billion), by (b) total U.S. population. Using these indices, we then compute total need for each state (including its local governments) by multiplying the "welfare need" by the state's welfare population, multiplying the "school need" by the state's school population, multiplying the "other need" by the state's total population, and then adding up these three components. This total is called the "relative expenditure need" and is given for each state under columns 1 and 4 of Table 3.

By construction, the total of these relative expenditure needs will equal the total of actual direct general expenditures by all state and local governments in 1960. This is why we refer to it as a "relative" measure. It is not meant to suggest in any way that absolute (1960) needs are at this same aggregate level.

A further caveat should be stated – we explicitly recognize that we have not here adequately disaggregated expenditures by cate-

[1]Relative expenditure needs will differ with the expenditure levels because of changing preferences as well as non-constant returns to scale.

gories, nor provided an adequate measure of relative need in the education and welfare categories. To do a proper job would require a major research effort, while this paper is only meant to be a suggestive first approximation.

Measuring Relative Capacity

The other side of the fiscal coin is fiscal "capacity". The Advisory Commission on Intergovernmental Relations has done considerable work on this subject. We make use of their definition of capacity which refers to the tax revenue which would be raised under a "representative tax system".

In 1960, state and local governments raised $36.4 billion through taxes. The difference between this figure and actual direct expenditures of $51.9 billion was obtained through user charges, other nontax state sources[2], and Federal transfers (of $7.0 billion). We examine two slight variations of the ACIR model tax system.

First, the revenue raised by every state under the representative tax system is proportionately increased until the total is equated with total expenditures at $51.9 billion. The resulting distribution is called "relative revenue capacity — without Federal transfers" and is given for each state under column 2 of Table 3. An alternative distribution is obtained by proportionately increasing the representative taxes up to $44.9 billion (total expenditures less Federal transfers) and then adding actual Federal transfers to achieve a total of $51.9 billion. The resulting distribution is called "relative revenue capacity — with Federal transfers" and is given for each state in column 5 of Table 3.

Relative Gaps

The next step is to compare relative expenditure need with relative revenue capacity for each state. This is done by subtracting the latter from the former, so that a positive result indicates a relatively poor state. These "relative gaps" have been computed using both measures of relative revenue capacity and are given under columns 3 and 6 of Table 3.

The relative nature of the analysis thus far should be stressed. By

[2]In a more intensive study, these sources should be included, substituting "revenue" for "taxable" capacity.

construction, the sum of the relative gaps for all states is zero. This is to say that there would be no aggregate gap in the state-local sector if this were so.

A mere reshuffling of existing state-local resources could close every fiscal gap. We do not mean to suggest that this represents the real world. Table 3 only shows that even without an aggregate U.S. gap, individual gaps will still occur because of the mismatch of needs and capacities.

B. Evaluation of Federal Programs

We thus come to the question of what policy measures may be taken to deal with this situation. One approach would be to impose taxes on surplus states and make transfers to deficiency states, holding the aggregate level of expenditures constant.

Raising the Gaps

Another approach, here followed, is to assume that aggregate needs are in fact greater than aggregate capacity at the state-local level and to assume that the Federal government provides the difference.[3] This presumably is the major problem and justification for revenue sharing and other Federal expenditure programs to deal with the state-local fiscal crisis. Three aggregate gaps are examined – $5, $10, and $20 billion. The relative expenditure needs are raised proportionately for each state, so as to increase the total from $51.9 to $56.9, $61.9, and $71.9 billion respectively. In each state, at each level, this new total is decreased by relative revenue capacity. The new distributions are called the distributions of "absolute gaps" for aggregate U.S. gaps of $5, $10, and $20 billion. These three distributions are the revenue capacity measures given in Table 4, for both the capacity measures excluding and including Federal transfers.

Measures of Effectiveness

The effectiveness of alternative Federal programs will here be measured in terms of the absolute gaps "closed" by the program. For

[3] In so doing, we overlook where the Federal taxes come from. Basically, this should be allowed for: Revenue sharing involves regional redistribution. Note, however, that Federal taxes reduce the income of *individuals*, while revenue sharing aids treasuries.

purposes of comparison, it is most meaningful to set the program level at the level of the aggregate U.S. gap. Programs can be inefficient in two ways: (1) money may be given to a state with a negative gap (capacity greater than need); or (2) money may be given to a state with a positive gap in excess of the size of its gap (thereby washing the difference between the grant and the gap). The simplest measure of the efficiency of the program would be the percentage of positive gaps which are closed. This is the measure we have adopted.[4]

The examination of a particular program will clarify the analysis. In Table 5 a revenue sharing plan, in which grants are distributed in proportion to state population, is evaluated. The distribution of a $5 billion program is given in column 1. Prior to the plan, Massachusetts, for example, has an absolute gap of $104 million when the aggregate U.S. gap is $5 billion (column 1, Table 4). Under a $5 billion per capita revenue sharing plan of this type, Massachusetts would receive $144 million (column 1, Table 5). Most of this would go towards closing the $104 million gap, although $40 million would be wasted. Thus, the "gap left open" is $40 million (column 2, Table 5). We next add up the *positive* gaps left open for all states, which is equal to $4,266 million (column 2, Table 5). This is then compared with the initial sum of the *positive* absolute gaps, which is $6,952 million (column 1, Table 4). The percentage of the initial positive gaps which are still open is 61.4[(4,266/6,952)·100]. Alternatively expressed, 38.6 percent of the positive gaps have been closed. This is the efficiency measure.

The analysis is repeated for each plan at all three levels of aggregate U.S. gaps, and using both capacity measures. The reason the efficiency of the plan increases at higher levels, even though the aggregate U.S. gap increases identically, is that there is less "waste" in grants to states with negative absolute gaps (i.e., revenue excess).

From Table 4, it can be seen that only two states do not need Federal aid at the $20 billion level, while 15 do not need aid at the $5 billion level (under the first capacity measure). A summary of the results for all of the programs evaluated is given in Table 2. The programs are described below.

[4]We do not mean to suggest that money not used for closing gaps is entirely wasted, nor should all gap-closing dollars be weighed equally. Ideally one would want to weigh each dollar in relation to the relative size of the gap closed, and to weigh dollars given in excess of the gap in relation to the degree of excess. Our cruder measure gives equal weights to gap-closing dollars and zero weights to all dollars which do not go towards closing gaps.

C. The Programs

Eight programs which give money directly to state treasuries were evaluated. In addition, one program in which the benefit to states was indirect was considered.

(1) *Revenue Sharing – Per Capita Plan:* Grants are distributed in proportion to the state's population.

(2) *Revenue Sharing – Administration Plan:* Grants are distributed in proportion to an index computed by multiplying the state's population proportion by the ratio of the state's own tax effort to the average tax effort for all states. Tax effort as used here refers to taxes raised from own sources as a fraction of total personal income of the state's residents.

(3) *Revenue Sharing – Javits Plan:* Eighty-five percent of the grant is distributed as in the Nixon plan. The remaining 15 percent is distributed to states with below-average per capita income. This part of the grant is distributed to the qualifying states in proportion to the difference between the average per capita income and the state's per capita income.

(4) *Welfare Assistance – Proportional to Potential Recipients Plan:* Grants are distributed in proportion to the state's welfare population. For this purpose, a proxy is used – the number of families with incomes below $2,000 (in 1960).

(5) *Welfare Assistance – Proportional to Own Welfare Expenditures Plan:* Grants are distributed in proportion to the state's expenditures on welfare from its own sources. For obtaining the Federal and state-local components of welfare expenditures for each state, it was necessary to use 1967 data and assume the same pattern for 1960.

(6) *School Assistance – Proportional to School-Age Population Plan:* Grants are distributed in proportion to the state's school-age population. For this purpose, a proxy is used – the number of individuals below the age of eighteen.

(7) *School Assistance – Proportional to Own School Expenditures Plan:* Grants are distributed in proportion to the state's expenditures on primary and secondary education from its own sources. For obtaining the Federal and state-local components of education expenditures for each state, it was necessary to use 1967

data and assume the same pattern for 1960.

(8) *Negative Income Tax Plan:* No grants are distributed directly to state treasuries. The grants go to low-income individuals. It was roughly assumed that a $20 billion program would eliminate the need for own welfare expenditures, and that any program below $20 billion would eliminate a proportional fraction of own welfare expenditures.

The imputed grant to the state was this savings in own expenditures, thus excluding such parts of the negative income tax payments as accrue to individuals other than the welfare population. As can be seen in Table 4, under these crude assumptions, only a small fraction of each program goes into gap closing.

(9) *Combination — Weighted Welfare and School Assistance Plan:* Twenty-two percent of the grant is distributed as in the "Welfare Assistance — Proportional to Potential Recipients Plan"; 78 percent of the grant is distributed as in the "School Assistance — Proportional to School-Age Population Plan." These percentages represent the actual breakdown between the sum of total expenditures for welfare and for primary and secondary education.

As noted earlier, the "Welfare Assistance — Proportional to Potential Recipients Plan" is the most efficient at every program level under either measure of revenue capacity (excluding or including Federal transfers). As the size of the programs increases, the effectiveness of the programs converges relatively; however, the absolute percentage difference between any two programs remains approximately constant. This is an important observation since the aggregate gap in the state-local sector is likely to be in the $5-$10 billion range in 1975 (see Table 1).

It is therefore particularly important which program is used to distribute Federal funds. This can be seen by comparing the Administration's revenue sharing plan with the welfare assistance plan based on potential recipients. At the $20 billion program level, the Administration plan is 89 percent [(75.9/85.6)·100] as effective as the welfare plan; at the $10 billion program level, it is 83 percent as effective; and at the $5 billion level, it is 80 percent as effective. The results are comparable for the other plans.

The poor showing of the negative income tax plan is explained in

part by the efficiency measurement here used. The objective of this approach is to close the poverty gap (while maintaining work incentives) and not the state-local fiscal gap. As a result of our assumptions, most of the benefits will go to poor individuals, so that the desirability of the plan cannot be judged merely on its impact on the fiscal gap.

D. The Data

The raw data were obtained from the following sources:

(1) *Population Per State:* U.S. Census Bureau, *1960 Census of Population: U.S. Summary,* Table 55.

(2) *Percent of State Population Under 18 Years Old: Ibid.,* Table 55.

(3) *Number of Families by State: Ibid.,* Table 137.

(4) *Percent of Families with Incomes Under $1,000: Ibid.,* Table 137.

(5) *Percent of Families with Incomes Between $1,000 and $1,999: Ibid.,* Table 137.

(6) *Relative Revenue Capacity by State (unadjusted):* Advisory Commission on Intergovernmental Relations, *Measures of State and Local Fiscal Capacity and Tax Effort* (October, 1962), Table 13.

(7) *Actual State and Local Tax Collections by State: Ibid.,* Table 10.

(8) *Actual Taxes as a Percent of Personal Income by State: Ibid.,* Table 24.

(9) *Total Direct General Expenditures by State:* U.S. Census Bureau, *Governmental Finances in 1960,* Table 16.

(10) *Direct General Expenditures for Welfare by State: Ibid.,* Table 18.

(11) *Direct General Expenditures for Local Schools by State: Ibid.,* Table 18.

(12) *Percent of Local School Expenditures Supported by Federal Aid, by State:* Advisory Commission on Intergovernmental Relations, *State and Local Finances: Significant Features, 1967-1970,* Table 14.

(13) *Percent of Welfare Expenditures Supported by Federal Aid, by State: Ibid.,* Table 16.

(14) *Federal Transfers to State-Local Governments, by States:* U.S. Census Bureau, *Governmental Finances in 1960,* Table 20.

TABLE 3

RELATIVE NEEDS, CAPACITIES, AND GAPS BY STATES, 1960
(MILLIONS OF DOLLARS)

STATES	Without Federal Transfers				With Federal Transfers			
	Rel. Expend. Need	Rel. Rev. Cpcty.	Rel. Gap	Rel. Gap % Of Rel. Exp. Needs	Rel. Expend. Need	Rel. Rev. Cpcty.	Rel. Gap	Rel. Gap % Of Rel. Exp. Needs
Alabama	1050.	624.	427.	68.	1050.	694.	357.	51.
Alaska	65.	46.	19.	42.	65.	74.	-10.	-13.
Arizona	387.	378.	9.	2.	387.	392.	-5.	-1.
Arkansas	589.	355.	234.	66.	589.	397.	193.	49.
California	4358.	5749.	-1391.	-24.	4358.	5702.	-1344.	-24.
Colorado	501.	579.	-79.	-14.	501.	597.	-96.	-16.
Connecticut	687.	820.	-134.	-16.	687.	776.	-89.	-12.
Delaware	127.	146.	-19.	-13.	127.	141.	-15.	-10.
Dist. of Col.	202.	277.	-75.	-27.	202.	302.	-100.	-33.
Florida	1447.	1452.	-6.	-0.	1447.	1442.	5.	0.
Georgia	1232.	783.	449.	57.	1232.	846.	386.	46.
Hawaii	180.	140.	40.	29.	180.	165.	15.	9.
Idaho	198.	208.	-11.	-5.	198.	220.	-22.	-10.
Illinois	2802.	3386.	-584.	-17.	2802.	3290.	-487.	-15.
Indiana	1347.	1371.	-25.	-2.	1347.	1326.	21.	2.
Iowa	811.	909.	-98.	-11.	811.	911.	-100.	-11.
Kansas	629.	709.	-80.	-11.	629.	709.	-80.	-11.
Kentucky	963.	649.	314.	48.	963.	700.	263.	38.
Louisiana	1030.	830.	-200.	24.	1030.	927.	103.	11.
Maine	278.	220.	58.	27.	278.	233.	45.	19.
Maryland	877.	833.	44.	5.	877.	801.	76.	9.
Massachusetts	1396.	1427.	-31.	-2.	1396.	1400.	-4.	-0.
Michigan	2246.	2249.	-3.	-0.	2246.	2169.	77.	4.
Minnesota	998.	1022.	-23.	-2.	998.	1028.	-30.	-3.
Mississippi	747.	357.	390.	109.	747.	411.	336.	82.
Missouri	1268.	1238.	29.	2.	1268.	1271.	-3.	-0.
Montana	197.	253.	-55.	-22.	197.	271.	-74.	-27.
Nebraska	412.	487.	-74.	-15.	412.	475.	-63.	-13.
Nevada	79.	121.	-43.	-35.	79.	126.	-48.	-38.
New Hampshire	168.	171.	-3.	-2.	168.	179.	-11.	-6.
New Jersey	1644.	1849.	-205.	-11.	1644.	1716.	-72.	-4.
New Mexico	293.	283.	10.	4.	293.	317.	-24.	-8.
New York	4533.	5082.	-549.	-11.	4533.	4891.	-358.	-7.
North Carolina	1434.	946.	488.	52.	1434.	974.	461.	47.
North Dakota	192.	198.	-6.	-3.	192.	220.	-27.	-12.
Ohio	2749.	2884.	-134.	-5.	2749.	2810.	-60.	-2.
Oklahoma	702.	629.	73.	12.	702.	676.	26.	4.
Oregon	502.	525.	-23.	-4.	502.	568.	-66.	-12.
Pennsylvania	3146.	2982.	164.	5.	3146.	2885.	261.	9.
Rhode Island	237.	215.	21.	10.	237.	218.	19.	8.
South Carolina	770.	415.	355.	85.	770.	450.	320.	71.
South Dakota	211.	211.	-1.	-0.	211.	226.	-16.	-7.
Tennessee	1122.	735.	387.	53.	1122.	789.	333.	42.
Texas	2907.	3339.	-431.	-13.	2907.	3278.	-370.	-11.
Utah	264.	263.	1.	0.	264.	291.	-28.	-10.
Vermont	112.	96.	17.	17.	112.	109.	3.	3.
Virginia	1184.	927.	257.	28.	1184.	932.	253.	27.
Washington	803.	846.	-43.	-5.	803.	862.	-59.	-7.
West Virginia	577.	397.	180.	45.	577.	428.	149.	35.
Wisconsin	1129.	1110.	19.	2.	1129.	1081.	49.	4.
Wyoming	95.	154.	-59.	-38.	95.	183.	-88.	-48.
TOTALS	51876.	51875.	00.	484.	51876.	51875.	00.	199.
POSITIVE TOTALS	51876.	51875.	4187.	794.	51876.	51875.	3749.	571.

TABLE 3 (CONTINUED)

RELATIVE NEEDS, CAPACITIES, AND GAPS BY STATES, 1960 (MILLIONS OF DOLLARS)

STATES	Per Capita Expenditure Need: % Of U.S. Average	Per Capita Revenue Capacity: % Of U.S. Average	School Pop. % Of U.S. Average Per Capita	Welfare Pop. % Of U.S. Average Per Capita
Alabama	111.	66.	110.	196.
Alaska	99.	70.	110.	57.
Arizona	103.	100.	111.	94.
Arkansas	114.	69.	104.	251.
California	96.	126.	97.	62.
Colorado	99.	114.	103.	73.
Connecticut	94.	112.	95.	43.
Delaware	98.	113.	102.	71.
Dist. of Col.	91.	125.	80.	65.
Florida	101.	101.	95.	129.
Georgia	108.	69.	109.	165.
Hawaii	98.	76.	111.	44.
Idaho	102.	108.	112.	87.
Illinois	96.	116.	95.	70.
Indiana	100.	102.	104.	83.
Iowa	102.	114.	100.	119.
Kansas	100.	113.	99.	103.
Kentucky	110.	74.	105.	197.
Louisana	109.	88.	113.	166.
Maine	99.	78.	100.	89.
Maryland	98.	93.	102.	66.
Massachusetts	94.	96.	93.	51.
Michigan	99.	99.	106.	72.
Minnesota	101.	103.	105.	96.
Mississippi	119.	57.	116.	264.
Missouri	101.	99.	94.	137.
Montana	101.	129.	108.	85.
Nebraska	101.	119.	99.	116.
Nevada	95.	147.	97.	53.
New Hampshire	96.	98.	97.	61.
New Jersey	94.	105.	92.	52.
New Mexico	106.	103.	120.	107.
New York	93.	105.	89.	61.
North Carolina	109.	72.	109.	174.
North Dakota	105.	108.	111.	122.
Ohio	98.	103.	101.	73.
Oklahoma	104.	93.	98.	158.
Oregon	98.	103.	100.	78.
Pennsylvania	96.	91.	94.	74.
Rhode Island	95.	87.	91.	74.
South Carolina	112.	60.	116.	181.
South Dakota	107.	107.	107.	156.
Tennessee	109.	71.	103.	194.
Texas	105.	120.	106.	137.
Utah	102.	102.	120.	59.
Vermont	100.	85.	102.	88.
Virginia	103.	81.	103.	127.
Washington	97.	103.	100.	67.
West Virginia	107.	74.	106.	166.
Wisconsin	99.	97.	103.	76.
Wyoming	100.	161.	108.	69.
TOTALS	—	—	—	—
POSITIVE TOTALS[1]	—	—	—	—

TABLE 4

ABSOLUTE GAPS BY STATES, 1960, FOR AGGREGATE U.S. GAPS OF 5, 10, AND 20 BILLION DOLLARS (MILLIONS OF DOLLARS)

STATES	Without Federal Transfers						With Federal Transfers					
	$5 Billion U.S. Gap		$10 Billion U.S. Gap		$20 Billion U.S. Gap		$5 Billion U.S. Gap		$10 Billion U.S. Gap		$20 Billion U.S. Gap	
	Abs. Gap	% U.S. Av. Gap	Abs. Gap	% U.S. Av. Gap	Abs. Gap	% U.S. Av. Gap	Abs. Gap	% U.S. Av. Gap	Abs. Gap	% U.S. Av. Gap	Abs. Gap	% U.S. Av. Gap
Alabama	528.	580.	629.	345.	832.	228.	458.	503.	559.	307.	762.	209.
Alaska	25.	404.	32.	252.	44.	175.	-3.	-52.	3.	24.	15.	61.
Arizona	46.	126.	83.	115.	158.	109.	32.	89.	69.	96.	144.	99.
Arkansas	291.	584.	348.	349.	461.	232.	250.	501.	306.	308.	420.	211.
California	-971.	-222.	-551.	-63.	289.	17.	-924.	-211.	-504.	-57.	336.	19.
Colorado	-30.	-62.	18.	18.	114.	59.	-48.	-97.	1.	1.	97.	50.
Connecticut	-68.	-96.	-2.	-1.	131.	46.	-23.	-33.	43.	30.	175.	62.
Delaware	-7.	-54.	6.	22.	30.	60.	-3.	-20.	10.	39.	34.	69.
Dist. of Col.	-56.	-262.	-36.	-85.	3.	3.	-81.	-378.	-61.	-143.	-22.	-26.
Florida	134.	97.	273.	99.	552.	100.	144.	105.	284.	103.	563.	102.
Georgia	568.	516.	686.	312.	924.	210.	505.	459.	624.	284.	861.	196.
Hawaii	58.	327.	75.	213.	110.	156.	32.	183.	50.	141.	84.	120.
Idaho	9.	46.	28.	74.	66.	88.	-3.	-17.	16.	43.	54.	73.
Illinois	-314.	-112.	-43.	-8.	497.	44.	-217.	-77.	53.	9.	593.	53.
Indiana	105.	81.	235.	90.	495.	95.	151.	116.	281.	108.	540.	104.
Iowa	-20.	-26.	58.	38.	214.	70.	-22.	-28.	56.	37.	213.	69.
Kansas	-19.	-31.	42.	34.	163.	67.	-19.	-32.	41.	34.	163.	67.
Kentucky	407.	480.	500.	295.	685.	202.	356.	420.	449.	265.	634.	187.
Louisiana	299.	329.	398.	219.	597.	164.	203.	223.	302.	166.	500.	138.
Maine	85.	316.	112.	207.	166.	153.	72.	267.	99.	183.	153.	141.
Maryland	128.	148.	213.	123.	382.	110.	160.	186.	245.	142.	414.	120.
Massachusetts	104.	72.	238.	83.	507.	88.	130.	91.	265.	92.	534.	93.

Michigan	213.	98.	430.	99.	863.	99.	293.	134.	509.	117.	942.	108.
Minnesota	73.	76.	169.	89.	361.	95.	67.	70.	163.	86.	355.	93.
Mississippi	462.	761.	534.	440.	678.	279.	408.	672.	480.	395.	624.	257.
Missouri	152.	126.	274.	114.	518.	108.	119.	99.	241.	100.	486.	101.
Montana	-36.	-193.	-17.	-46.	21.	27.	-55.	-293.	-36.	-96.	2.	3.
Nebraska	-34.	-87.	5.	7.	85.	54.	-23.	-58.	17.	21.	96.	61.
Nevada	-35.	-441.	-27.	-173.	-12.	-39.	-40.	-502.	-32.	-204.	-17.	-54.
New Hampshire	13.	77.	29.	87.	62.	91.	6.	33.	22.	64.	54.	80.
New Jersey	-47.	-28.	112.	33.	429.	63.	86.	51.	245.	72.	561.	83.
New Mexico	39.	146.	67.	126.	123.	116.	4.	16.	33.	61.	89.	84.
New York	-112.	-24.	325.	35.	1198.	64.	79.	17.	516.	55.	1390.	74.
North Carolina	627.	493.	765.	301.	1041.	205.	599.	472.	737.	290.	1014.	200.
North Dakota	12.	71.	31.	88.	68.	97.	-9.	-50.	10.	28.	47.	66.
Ohio	131.	48.	396.	73.	925.	85.	205.	76.	470.	87.	1000.	92.
Oklahoma	141.	217.	208.	160.	344.	132.	93.	144.	161.	124.	296.	114.
Oregon	25.	51.	73.	74.	170.	86.	-18.	-36.	31.	31.	128.	65.
Pennsylvania	467.	148.	770.	122.	1377.	109.	564.	179.	867.	137.	1473.	117.
Rhode Island	44.	184.	67.	140.	113.	118.	41.	173.	64.	134.	110.	115.
South Carolina	429.	646.	503.	379.	651.	245.	394.	593.	468.	352.	617.	232.
South Dakota	20.	104.	40.	105.	81.	106.	5.	25.	25.	66.	66.	86.
Tennessee	496.	498.	604.	304.	820.	206.	441.	444.	549.	276.	766.	192.
Texas	-151.	-57.	129.	24.	689.	65.	-90.	-34.	190.	36.	751.	70.
Utah	27.	107.	52.	105.	103.	103.	-2.	-10.	23.	46.	74.	74.
Vermont	28.	258.	38.	176.	60.	138.	14.	128.	25.	114.	46.	107.
Virginia	371.	336.	485.	219.	714.	161.	367.	332.	481.	217.	709.	160.
Washington	34.	43.	112.	70.	267.	84.	19.	24.	96.	60.	251.	79.
West Virginia	236.	455.	291.	281.	403.	194.	205.	395.	260.	251.	372.	179.
Wisconsin	128.	116.	237.	107.	454.	103.	157.	143.	266.	121.	484.	110.
Wyoming	-50.	-541.	-41.	-221.	-22.	-60.	-79.	-857.	-70.	-379.	-51.	-139.
TOTALS	5000.	—	10000.	—	20000.	—	5000.	—	10000.	—	20000.	—
POSITIVE TOTALS	6952.	—	10719.	—	20036.	—	6659.	—	10704.	—	20092.	—

TABLE 5

—— REVENUE SHARING —— PER CAPITA PLAN: DISTRIBUTION AND EFFECTIVENESS OF GRANTS FOR PROGRAMS AND AGGREGATE U. S. GAPS OF 5, 10, AND 20 BILLION DOLLARS (FIGURES IN MILLIONS OF DOLLARS)

STATES	Without Other Federal Transfers						With Other Federal Transfers					
	$5 Billion U.S. Gap and Program Level		$10 Billion U.S. Gap and Program Level		$20 Billion U.S. Gap and Program Level		$5 Billion U.S. Gap and Program Level		$10 Billion U.S. Gap and Program Level		$20 Billion U.S. Gap and Program Level	
	Grant	Gap	Grant	Gap	Grant	Gap	Grant	Gap	Grant	Gap	Grant	Gap
Alabama	91.	437.	182.	447.	364.	468.	91.	367.	182.	377.	364.	397.
Alaska	6.	19.	13.	19.	25.	19.	6.	-10.	13.	-10.	25.	-10.
Arizona	36.	10.	73.	11.	145.	12.	36.	-4.	73.	-3.	145.	-1.
Arkansas	50.	241.	100.	248.	199.	262.	50.	200.	100.	207.	199.	221.
California	438.	-1409.	876.	-1427.	1753.	-1464.	438.	-1362.	876.	-1380.	1753.	-1417.
Colorado	49.	-79.	98.	-80.	196.	-81.	49.	-97.	98.	-97.	196.	-99.
Connecticut	71.	-138.	141.	-143.	283.	-152.	71.	-94.	141.	-98.	283.	-107.
Delaware	12.	-19.	25.	-19.	50.	-20.	12.	-15.	25.	-15.	50.	-16.
Dist. of Col.	21.	-77.	43.	-79.	85.	-83.	21.	-102.	43.	-104.	85.	-107.
Florida	138.	-5.	276.	-3.	552.	-0.	138.	6.	276.	8.	552.	10.
Georgia	110.	458.	220.	467.	440.	484.	110.	395.	220.	404.	440.	421.
Hawaii	18.	40.	35.	40.	71.	39.	18.	15.	35.	14.	71.	14.
Idaho	19.	-10.	37.	-10.	74.	-9.	19.	-22.	37.	-21.	74.	-20.
Illinois	281.	-595.	562.	-606.	1124.	-628.	281.	-498.	562.	-509.	1124.	-531.
Indiana	130.	-25.	260.	-25.	520.	-25.	130.	21.	260.	21.	520.	20.
Iowa	77.	-97.	154.	-96.	308.	-93.	77.	-99.	154.	-97.	308.	-95.
Kansas	61.	-80.	121.	-80.	243.	-80.	61.	-80.	121.	-80.	243.	-80.
Kentucky	85.	322.	169.	330.	339.	347.	85.	271.	169.	279.	339.	295.
Louisiana	91.	208.	182.	217.	363.	234.	91.	112.	182.	120.	363.	137.
Maine	27.	58.	54.	58.	108.	58.	27.	45.	54.	45.	108.	44.
Maryland	86.	42.	173.	40.	346.	36.	86.	74.	173.	72.	346.	68.

Massachusetts	144.	-40.	287.	-49.	574.	-67.	144.	-13.	287.	-22.	574.	-40.								
Michigan	218.	-5.	436.	-6.	873.	-10.	218.	75.	436.	73.	873.	70.								
Minnesota	95.	-22.	190.	-21.	381.	-19.	95.	-28.	190.	-27.	381.	-25.								
Mississippi	61.	402.	121.	413.	243.	435.	61.	348.	121.	359.	243.	381.								
Missouri	120.	31.	241.	33.	482.	36.	120.	-1.	241.	0.	482.	4.								
Montana	19.	-55.	38.	-55.	75.	-55.	19.	-74.	38.	-74.	75.	-73.								
Nebraska	39.	-74.	79.	-73.	157.	-73.	39.	-62.	79.	-62.	157.	-61.								
Nevada	8.	-43.	16.	-43.	32.	-44.	8.	-48.	16.	-48.	32.	-49.								
New Hampshire	17.	-4.	34.	-5.	68.	-6.	17.	-11.	34.	-12.	68.	-13.								
New Jersey	169.	-216.	338.	-227.	677.	-248.	169.	-83.	338.	-94.	677.	-115.								
New Mexico	27.	12.	53.	14.	106.	17.	27.	-22.	53.	-20.	106.	-17.								
New York	468.	-580.	936.	-611.	1872.	-673.	468.	-389.	936.	-420.	1872.	-482.								
North Carolina	127.	500.	254.	511.	508.	533.	127.	472.	254.	483.	508.	506.								
North Dakota	18.	-5.	35.	-4.	71.	-2.	18.	-26.	35.	-25.	71.	-24.								
Ohio	271.	-140.	541.	-146.	1083.	-157.	271.	-66.	541.	-72.	1083.	-83.								
Oklahoma	65.	76.	130.	78.	260.	84.	65.	28.	130.	31.	260.	37.								
Oregon	49.	-24.	99.	-25.	197.	-27.	49.	-67.	99.	-68.	197.	-70.								
Pennsylvania	316.	152.	631.	139.	1262.	114.	316.	248.	631.	236.	1262.	211.								
Rhode Island	24.	20.	48.	19.	96.	17.	24.	17.	48.	16.	96.	14.								
South Carolina	66.	362.	133.	370.	266.	386.	66.	328.	133.	335.	266.	351.								
South Dakota	19.	1.	38.	2.	76.	5.	19.	-14.	38.	-13.	76.	-10.								
Tennessee	99.	396.	199.	405.	398.	422.	99.	342.	199.	350.	398.	368.								
Texas	267.	-418.	534.	-405.	1068.	-379.	267.	-357.	534.	-344.	1068.	-318.								
Utah	25.	2.	50.	2.	99.	3.	25.	-27.	50.	-27.	99.	-25.								
Vermont	11.	17.	22.	17.	43.	17.	11.	3.	22.	3.	43.	3.								
Virginia	111.	261.	221.	264.	442.	271.	111.	256.	221.	260.	442.	267.								
Washington	80.	-45.	159.	-47.	318.	-52.	80.	-61.	159.	-63.	318.	-67.								
West Virginia	52.	184.	104.	188.	207.	195.	52.	153.	104.	157.	207.	164.								
Wisconsin	110.	18.	220.	16.	441.	14.	110.	47.	220.	46.	441.	43.								
Wyoming	9.	-59.	18.	-59.	37.	-59.	9.	-88.	18.	-88.	37.	-88.								
TOTALS	5000.	2.	10000.	2.	20000.	2.	5000.	1.	10000.	1.	20000.	1.								
POSITIVE TOTALS	5000.	4266.	10000.	4347.	20000.	4508.	5000.	3822.	10000.	3896.	20000.	4047.								
EFFICIENCY	38.6		59.4		77.5		42.6		63.6		79.9									

DISCUSSION

GEORGE F. BREAK

Though Pechman's return visit to revenue sharing is a brief one, his comments do summarize clearly and succinctly the distinctive features of the plan, and he then goes on to discuss three important, but unresolved, questions concerning the specific nature of future federal aids to state and local governments. Like Musgrave and Polinsky, he is critical of the proposal to adopt a fractional credit against federal personal income tax liabilities for income taxes paid to either state or local governments. Since I am in general agreement with that position, I shall not discuss it further here.

Like Musgrave and Polinsky, too, Pechman emphasizes the importance of conditional federal grants, stating that "the adoption of revenue sharing should not be the occasion for reducing conditional grants."[1] If this means not reducing them in absolute amount, I am sure that there would be wide agreement with Pechman's position. If it means not reducing their future rate of growth, however, the matter is much more complex and controversial.

There is, I believe, a strong possibility that enactment of a revenue sharing plan by the present Congress would lower the future growth rate of categorical grants. It is over the terms of this trade-off that many critics and proponents of revenue sharing appear to disagree most fundamentally.

Since the proposition is well-established that matching, conditional grants are the preferred Federal policy instrument for dealing with state-local programs with significant benefit spillouts, my remarks here will concentrate on the financing of non-spillout, state-local programs. If there is a case for Federal aid for such governmental activities, for reasons to be discussed later, unconditional grants of one sort or another are the obvious first choice. The questions before us, then, concern the nature, and strength, of the case for federal aid for local-benefit public programs and, if there is such a case, the extent to which Heller-Pechman grants are capable of satisfying it.

The Case for Federal Aid for Local Programs

Musgrave and Polinsky begin their paper with a very helpful

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[1] Pechman, p. 4.

summary of the principles of fiscal federalism and with a fiscal forecast which, at least at the very broad macro level, is a good deal more optimistic than many that we have seen in the past. This sets the stage for a critical analysis of revenue sharing which, I must confess, ended up by making me more favorable to the plan than I had previously been.

I quite agree with them that "the redistributive function of fiscal policy (i.e. progressive taxation and transfers) should be centralized at the Federal level,"[2] and "that concern with poverty should be given top priority."[3] My conclusion, however, is that we need both aid to poor people and aid to poor governments, that income maintenance programs are capable of achieving only the former goal, and that revenue sharing, in a form not very different from the original Heller-Pechman plan, is a simple, and reasonably effective, means of raising the level of public service consumption to acceptable standards for people who otherwise would not be able to achieve them.

The first point, which is a rather complex one, concerns the extent to which a national income-maintenance program may be expected to raise consumption levels of the poor not only for private goods and services, but for public ones as well. Musgrave and Polinsky note the direct impact on state and local budgets of the reduced welfare expenditures which Federal assumption of full responsibility for redistributive fiscal functions would permit. In addition, one might hope that substantial alleviation of poverty would permit considerable reductions in such state and local government programs as police and fire protection, public housing, and general government.

Even when realized, however, these economies are not likely to go very far toward eliminating those horizontal fiscal imbalances which Musgrave and Polinsky rightly stress in their paper. This is clearly indicated in their Table 2 where the efficiency measures for the Negative Income Tax Plan fall far below the corresponding measures for the other programs considered.

There is, however, a third way in which a national program of income maintenance could provide some help to poor governments, and it has to do with the interaction between Negative Income Tax (NIT) support standards and state-local tax burdens. Consider, for

[2]Musgrave and Polinsky, p. 2

[3]Musgrave and Polinsky, p. 7.

example, the following basic definition of needs standards for families of any given size:

(1) $N = BA + Y_m(1 - t_o)$, where

N = the basic needs standard for a family of given size,
BA = the basic allowance to be provided by the NIT plan for a family of that size,
Y_m = the minimum earning power of that family, given the non-market commitments of its members, and
t_o = the offsetting tax rate to which all family income, other than the basic allowance itself, is to be subject.

For a family of four with one able-bodied, but unskilled, worker, the appropriate entries in equation (1) might be:

N = \$3,600 a year
BA = 1,600 a year
Y_m = 3,000 a year
t_o = 0.33.

Impact of State and Local Taxes

Consider, now, the impact on these values of state and local taxes paid by the poor to finance public services for the poor. Retail sales or property taxes that are shifted forward to the consumer should increase the size of N, the minimum amount of money needed by a family of given size to buy an adequate market basket of private goods and services. Sales or property taxes, on the other hand, that are shifted back to factory owners should reduce the value of Y_m, the minimum amount that an unskilled worker can earn by working full time for a year. In either case, state-local taxes paid by the poor to finance public services to themselves should bring forth additional income-maintenance payments on the part of the Federal government, and to this extent it may be said that a national NIT program would help poor people buy government benefits for themselves.

Though this is true enough for the public services that the poor are already buying for themselves, there seems little hope that a NIT plan would give them much muscle at the margin. We may assume, I think, that NIT needs and basic allowance standards will be set, at least for some considerable time to come, at average national levels, rather than at amounts based on the specific price and wage rates prevailing in different localities and regions. This being the case, low-income families in any one area could buy additional public

services for themselves only at their own expense (in the form of higher state-local tax rates), at least until a sufficient number of other areas had behaved similarly so as to raise the national average NIT support levels.

Moreover, even if federal NIT payments were made sensitive to differential movements in local and regional prices and wage rates, achievement of acceptable public good standards might well be a difficult boot-strap operation for all poor families except those lucky enough to live in communities with average, or above-average, income levels. Much would depend on the standards set for minimum local public service, and maximum local tax rate, levels – that is, on the definition of "poor governments" adopted by the public.

Standards for Minimum Local Service

One definition, a relatively stringent one, would be any community unable to finance a minimum local public service offering without forcing some of its citizens below minimum private consumption standards. By this test, any community containing a significant number of poverty-line families would have little, or no, ability to afford additional local public goods, simply because most feasible financing plans would impose some burdens on poor households. If such communities provided only substandard public service levels, therefore, all poor residents would be entitled to an NIT increment equal to their share of the tax costs involved in raising local government expenditures by the required amounts. If these amounts were large, moreover, many nonpoor households might be forced into the same situation. A more liberal definition of a poor government, and one suggested by Musgrave and Polinsky themselves, would be any community unable to afford *average* public service levels at *average* tax rates.

Such a standard would distinguish sharply between poor people and poor governments, since under it, a government could be poor even though it contained no families with disposable incomes below the NIT private-needs standard. Clearly, a national NIT program would be an inefficient way of eliminating fiscal deficiencies of this sort, and one's attention is turned instead to some kind of unconditional grant program.

Ideal Grant Formulas

The ideal grant formula for this purpose would be one long

familiar from the education field:

(2) $G_i = MC_i - RC_i$, where

G_i = the grant paid to the i-th government, perhaps with the constraint that $G_i \geqslant 0$.
MC_i = the minimum cost of providing the minimum public goods standard in the i-th government, and
RC_i = the revenue capacity of the i-th government, perhaps defined as the yield in that jurisdiction of the ACIR's representative tax system.

Because of the great number and diversity of local governments in this country, however, such a program would be extremely difficult to set up and very costly to administer at the Federal level, even if the data needed to compute minimum costs and revenue capacities were readily available. Since they are not, revenue sharing, with the appropriate distribution formulas, becomes an attractive policy possibility.

Looked at solely as a means of helping poor governments, federal block grants would have three main characteristics:

(1) Aid would not be confined to poor states, since even the richest ones contain poor local governments.

(2) For states with above-average revenue capacities, pass-through requirements, if any, should be close to 100 percent since those state governments, in the absence of special needs for state programs, would not suffer from any general fiscal deficiency. Pass-through percentages would be lower for states with below average revenue capacities, and very likely they would be lower, the greater the gap between state's revenue capacity and the average for the nation.

(3) To maximize the proportion of block grant funds going to poor governments, both allocation and pass-through formulas should presumably be based directly on the relative numbers of low-income families, or relative amounts of federal-state-local income-maintenance expenditures, in the receiving jurisdictions. Calculations similar to those presented by Musgrave and Polinsky in their Table 2 could be used to compare the relative efficiencies of alternative rules.

Revenue sharing, however, should not be evaluated solely by its ability to assist poor state and local governments. Indeed, one of the

great attractions of the plan is its ability to contribute to the solution of a wide variety of state-local fiscal problems. While for each of these, there is a superior policy instrument, revenue sharing represents a second- or third-best solution in most cases.

A helpful analogy may be to consider a student trying to choose a college to attend when university A has the best man in the country in one of his fields of interest but is rather weak in most of the others, university B has the best man in another field but is weak in the others, and so on down to university G which, though lacking entirely a first-place man, does have the second- or third-best in all of the student's fields of interest. Under such circumstances the student might well decide to go to university G. Of course, if one of the other universities suddenly acquired several of the first-rank professors, the attractiveness of G would be considerably weakened. So it would be with revenue sharing as the Federal government adopted, and implemented effectively, more and more of the superior, fiscal-aid policy instruments.

How well it has done in this respect, and how well it is likely to do in the near future, is largely a matter of personal judgment. Like Pechman, I tend to feel that revenue sharing would be a useful addition to our federal fiscal system. As he put it when he first heard my student analogy: "There is no problem of choice at all. If the student wants a liberal education, university G wins hands down!"