Economic Policy Institute

Briefing Paper

1660 L Street, NW • Suite 1200 • Washington, D.C. 20036 • 2021775-8810

REVENUE SHARING AS A PUBLIC INVESTMENT

Why Unrestricted Aid to Local Governments Will Stimulate Municipal Capital Expenditures

By Bruce Wallin

INTRODUCTION

Two commitments made by President Clinton and the Democratic majority of the 103rd Congress were (1) to push the economy out of recession and (2) to improve the nation's economic competitiveness. A proposal that could serve both objectives is the Clinton campaign call for an immediate annual increase of $20 billion in infrastructure spending-building, maintaining, and improving airports, mass transit, roads, bridges, educational facilities, etc. This paper provides new evidence that one tool for furthering this objective is the provision of general fiscal assistance-money without strings attached-to local governments.

Critics worry that federal aid to state and local governments for infrastructure projects could fail in two different ways: it could be used by recipient politicians to support payrolls, or it could evaporate in tax cuts. Neither outcome, of course, speaks to the competitiveness problem. Although under certain circumstances the federal government could defend these uses, neither ranks high among current federal budget priorities.

This paper shows that local governments' uses of general assistance transcend the narrow expectations fostered by conventional wisdom. Such skepticism is founded on an incomplete picture of the decision-making processes of local government officials and the purposes to which general assistance was put in the past.

THE HISTORY OF REVENUE SHARING

Federal general assistance to state and local governments originated in the early 1970s. Reacting to the centralizing trend of federal aid to state and local governments, President Richard Nixon proposed a "new federalism" in his 1971 State of the Union message. The Administration's "new American revolution" began with the passage of the State and Local Fiscal Assistance Act of 1972, popularly known as general revenue sharing.

The program allocated nearly $7 billion (over $20 billion in today's dollars) for annual distribution to state and local governments. The funds were automatically transferred by formula without annual appropriation by Congress. Within broad reporting and anti-discrimination requirements, recipient governments were free to spend the revenue as they wished. Initially authorized for a five-year period, the program was extended in 1976 and 1980, reauthorized for local governments only in 1983, and finally terminated in 1986.

One motivation for the legislation was the anticipation that local decision making would be rejuvenated. Local officials, free of the restrictions surrounding existing federal aid programs, would be better able to address the particular problems facing their own jurisdictions. Nixon predicted a "burst of creative energy" at the local level.

A better understanding of municipal budgeting would have tempered this optimism. Due to balanced budget constraints, steady expenditure pressure, and limited revenue alternatives, the local budgeting process is highly structured and routinized, dominated by the chief executive (either a city manager or a mayor), and relatively insulated from the outside world (Crecine 1969). Budgets tend to vary incrementally from one year to the next (Meltsner and Wildavsky 1970). Stability in intergovernmental assistance is very valuable to its prospective recipients (Pressman 1975).

Economists expect general assistance funds to be spent much like locally raised revenue. In contrast, categorical matching grants' are thought to change the composition of local budgets because a "price effect" encourages funding of the targeted service beyond traditional levels, to some extent drawing resources away from spending that is not subsidized in this way. An unrestricted grant in theory simply helps the recipient government do everything it was otherwise inclined to do. The possibility of tax cuts is not precluded, but there is no incentive to change local budget priorities (Oates 1972; Break 1980).

Given the difficulty of influencing local budgets, is there a good case for granting them general assistance in today's economic and fiscal environment? In fact there is, but it stems from a different picture of how local governments spend money and from a contemporary view of the sort of spending that would be most beneficial to today's economy in light of concerns with competitiveness and growth.

SURVEY OF LOCAL CHIEF EXECUTIVES

This study's findings are based on an analysis of the effects of general revenue sharing over the life of the program, as seen by local chief executives in 100 large cities in two states. The data are the result of a series of surveys conducted over the past 20 years. In October 1972, the first questionnaires were sent to the city manager or mayor in 67 California and 33 New Jersey cities. (These included all cities in each state with populations over 50,000, plus "central cities"—cities designated by the US. Bureau of the Census as the hub of a standard metropolitan statistical area-in New Jersey.) This sample represents about 20% of all U.S. cities with populations exceeding 50,000.

The first survey sought to record the impressions of local chief executives before the arrival of the first installment of revenue sharing. In a followup survey conducted 18 months later in early 1974, local chief executives were asked to record their impressions of the program's initial impact. This before-and-after look allows a critical examination of the effect of local variables on allocation decisions.

In March 1984, another followup survey was sent to the same 100 local chief executives to determine the program's ongoing impact, and in particular to try to estimate the impact of local tax and spending limits (which had proliferated after California's Proposition 13[2]) on the use of revenue-sharing funds. A final survey was mailed in 1988, two years after the general revenue-sharing program had been terminated, to determine the cities' uses of the last of their grants, their response to the loss of funds, and their general budget situation.

The survey approach was chosen for its low cost and accessibility, relative to the participant-observer approach." Statistical analysis of expenditures posed a problem; since nearly all local governments received funds, there were few control cities available for comparison (Larkey 1979). More importantly, the survey and interview method is the better way to get at the most interesting questions: How and why were the decisions on use of revenue-sharing funds made? These surveys capture the attitudes, opinions, and beliefs of the chief executives on the impact of general revenue sharing in their cities. This study is not trying to gauge the actual use of funds in an accounting sense; rather, it seeks to record and analyze the process, politics, and calculations that influenced spending decisions-the better to inform future policy.

California and New Jersey were chosen for several reasons, the most important being to maximize response to the survey. The author had worked for two years as a special assistant to the mayor of Trenton, New Jersey, and had helped to form the first lobby for New Jersey's mayors. A cover letter for the surveys from the mayor carried great weight and was expected to improve the rate and candor of the responses. Similarly, a cover letter from the director of the Institute for Governmental Studies at the University of California, Berkeley, was expected to give the survey strong legitimacy in that state.

Response rates confirmed these hopes. The response rate to the first survey was 83%, increased to 86% for the second, and rose to 90% for the third and fourth.

The cover letters and subsequent response rates lend greater credibility to the survey responses.

Respondents were informed that no individual cities would be identified. A great convergence in local chief executives' thinking, even over time, further suggests honest appraisals, especially given the likelihood that different (newly elected or appointed) mayors and city managers responded to the survey in different years. Finally, other surveys, including some national samples, presented responses that substantially confirmed the general findings here (Caputo and Cole 1977).

In summary, the study chose to get a complete and detailed look at two states rather than a superficial look at many. This selectivity provides an advantage in trying to understand local fiscal decisions. Research that groups data from cities in a large number of states loses detail and can yield misleading results. For example, in many states elementary and secondary education is part of the municipal government budget, but in others it is not. Health care is a county function in some states, a city responsibility in others. Therefore, an inference that X percent of "all" city expenditures of revenue-sharing funds were devoted to health care would be misleading.

In addition, the two states provide some interesting contrasts. The Northeastern industrial state of New Jersey had been in a period of relative economic decline, while California continued to prosper in the Sunbelt. When the surveys began in 1972, New Jersey had no state income tax, so a larger-than-average percentage of total government revenue was raised by local governments through the property tax. California had a progressive state income tax, local sales tax options, and about average reliance on the property tax. Finally, New Jersey is dominated by the strong mayor-weak council form of government, while California predominantly follows what is called the reformist, city council-city manager model. Given the contrasts between the two states, it would be difficult to argue that the observed decisions were the product of any particular form of state government or tax structure.

The Survey Questions

The surveys asked local chief executives to indicate their anticipated (1972) and actual uses of their revenue-sharing grants. The following question was asked in each survey: "To what purpose(s) was the amount allocated to your city for ____ fiscal year put?" The choices given were as follows:

(1) reduce property taxes
(2) expand existing services
(3) maintain existing services
(4) capital improvements
(5) initiate new programs
(6) other

While most choices are clear, "maintain existing services" warrants some explanation. Under expenditure pressure due to rising salaries (which represent about 75% of local budgets) and inflation, and with little discretion over local revenue sources (due to legal or political considerations), this choice refers to the use of revenue-sharing funds to help pay the increased cost of existing local public services.

Respondents were asked to rank uses. To prevent double-counting, these broad-use questions were kept separate from questions asking officials to report functional area expenditures (e.g., public safety, housing, transportation, etc.). A new health center, for example, could fall under "capital improvements" as well as "health." Many other studies of revenue sharing fail to make this distinction.

Respondents were not asked to report the percentages spent in each category, because this would entail the formulation of a hypothetical budget assumed to prevail in the absence of expected revenue-sharing grants. For instance, if a community spent $1 million, of which $50,000 was financed by the grant program, without any grant it is possible that only $950,000 would be spent, that the difference would be made up by additional taxes, that some compromise between the two would be reached, or that something altogether different would result. If the total public budget is larger or smaller, the composition could be adjusted at the same time. Therefore, the question of exactly how much of a grant is used for any particular purpose is not as simple as it might appear. Information gathered here is intended to reveal the highest-priority uses for the cities.

USES OF GENERAL REVENUE-SHARING FUNDS

A summary of the top-ranked uses of general revenue-sharing funds for the cities in our sample is found in **Table 1.** The 1972 "actual" column presents uses reported in the 1974 survey. The results were surprising: There was a rise in the use of revenue-sharing funds by cities to maintain existing services, and there was a preference for using funds for capital improvements.

Revenue Sharing and Existing Services

The dramatic rise in the percentage of city leaders who said that the primary use of revenue-sharing funds was to maintain existing services can be explained fairly easily. In the initial (1972) survey, this use was found to positively correlate with cities whose chief executives characterized their financial condition as "poor" and for whose cities the financial outlook was seen as "discouraging." Similarly, the 1974 survey uncovered a positive relationship between a "worsened" financial condition and the use of revenue-sharing funds to maintain existing services. By 1984, under the preceding criterion, the data indicate that many if not most cities were financially strained.

This was not far from the truth. Strong growth on the expenditure side, coupled with balanced-budget restraints and taxpayer opposition to property tax hikes (typified by the "tax revolts" of the late 1970s), encouraged a search for flexible revenue sources merely to meet existing program needs. Cities may have wanted to do more, but they had to continue to perform their basic functions.

It is important to note that while the cities' first revenue-sharing grants amounted to about 5-7% of their budgets, aid levels fell to about 3.5% by 1984 and still less in 1987. Ultimately, general revenue sharing came to be treated as ordinary municipal general revenue.

It is also important to note that no more than 11% of the respondents in any year suggested

TABLE 1
General Revenue Sharing Primary Uses,
California and New Jersey Cities

Use	1972 (Expected)		1972 (Actual)		1974		1984		Last Full Allocation 1988	
	#	o	#	o	#	0,		o	#	o
Capital Improvements	42	58%	47	59%	33	41%	17	20%	29	35%
Reduction of Property Taxes	17	24	9	11	9	11	8	9	6	7
Maintainance of Existing Services	7	10	20	25	32	40	60	70	42	50
Expansion of Existing Services	3	4	3	4	4	5	1	1	2	4
Initiation of New Programs	2	3	0	_	2	3	0	__	1	1
Other	1	1								
	N=72		N=79		N=80		N=86		N=84	

reducing property taxes as the primary use of the general revenue-sharing funds, and all who did suggest this were from New Jersey. With no state income tax and little state aid to local governments, property taxes had reached near-confiscatory levels in New Jersey. By 1972, the effective property tax rate in Trenton, for example, was 8%, meaning that every 12 years the entire value of a home was paid in property taxes. Property tax levels in New Jersey were 176% of the national average (U.S. ACIR 197 1). The reported use of at least some discretionary funds for property tax relief became a sine qua non of New Jersey's local politics, even in the face of future political costs. If the funds were used for property tax relief and the program ended, city officials would have to raise tax rates to meet rising expenses and to replace the lost funds. Those who did use revenue sharing in this manner must have been under severe political pressure from taxpayers.

Revenue Sharing and Capital Expenditures

Survey responses and interviews confirmed that the preference for using general revenue-sharing grants for capital improvements was due to the well-founded fear that these grants might be terminated. The program was originally authorized for a five-year period, with subsequent four- and three-year renewals. The initiation of new programs or the expansion of services with what were viewed as potentially temporary federal funds was to be avoided, since such a policy would accustom the public to services that would later have to be terminated or supported by local tax increases. Most importantly, the creation of new public-sector jobs was avoided, since the political repercussions of terminating employment would be great. (While categorical grant programs may also be temporary, local officials do not have the discretion to spend according to the same political sensitivity-the program areas and activities are designated by the provisions of the grant.)

Capital improvements offered the perfect hedge against an uncertain future. New buildings, facilities, and equipment purchased with revenue-sharing funds would benefit the community after the program ended and require no more than operating expenditures in local budgets. For these reasons, several of the professional journals of local government officials recommended using the funds for capital improvements.

Public Management editorialized: "Due to the present short-term nature of the funding *(five* years), I have suggested to Claremont's (California) city council that it would be a mistake for the city to become dependent on revenue sharing for operating expenses such as salaries or hiring of additional employees, at least until the program develops a track record. I have suggested that the council consider limiting the expenditures from revenue sharing to low-maintenance capital outlays, experimental programs, and other non-recurring types of expenditures, such as special studies."

Similarly, the *Policy Guidelines* on use of revenue-sharing funds for San Francisco stated: "Since General Revenue Sharing is a five-year program, low priority, except in special circumstances, should be given to projects which involve new personnel."

To test the importance that the short-term nature of the funding played on revenue-sharing uses, both the 1974 and 1984 surveys asked local chief executives, "If revenue sharing were to be discontinued, in what way would you allocate your last allocation." In both years, the number suggesting capital improvements as the highest priority was higher than the actual reported uses in those years. How important was fear of program termination? The 1984 survey asked local officials their preferred reform of the general revenue-sharing program. "Program made permanent" ranked first at 59% of those responding, with "more funds allocated" a distant second at 23%.

Intelligent fiscal policy also made for good politics. Local chief executives did not want to be saddled with ongoing expenses due to, but no longer funded by, revenue sharing. To test this hypothesis, the 1974 survey asked, "What, in your opinion, is the politically 'safest' use of revenue sharing funds?" The choices offered were the following:

(1) reduce taxes
(2) capital improvements
(3) new programs
(4) new jobs
(5) maintain services
(6) increase existing services

Of 68 local chief executives responding, 46 ranked capital improvements first. Remarkably, none mentioned "new jobs."

Impact of the Loss of Funds

The most recent survey in this study sheds additional light on the likely use of new unrestricted federal funds. First, local chief executives were asked, "How did your city respond to the loss of funds due to termination of General revenue sharing?" The results were as follows:

Reduced capital improvement projects	30%
Reduced operating expenditures	19%
Raised local taxes	14%
Used tax base growth	10%
Increased use of user fees, etc.	9%
No effect	9%

City capital-improvement projects took the biggest hit in response to the loss of unrestricted federal aid.

City officials were presented with a scenario involving an annual 10% increase in new federal revenue-sharing funds and asked to rank potential uses. The results were as follows:

Capital Improvements	52%
Maintain existing services	23%
Reduce property taxes	14%
Expand existing services	10%
Initiate new programs	1%

It is clear that cities have a backlog of capital projects that they are unable to fund, and a majority would more than likely use new federal unrestricted funds to get those projects under way. Again, all of the property tax reduction cities were in New Jersey, where rates remained high. The 1988 survey also asked local officials if they would like the option of adopting a new local tax, and to what purpose the funds would be put. An astonishing 86% said yes, with capital improvements again the leading choice for use of the funds at 43%.

In what specific areas might these funds be used? Local chief executives were asked in each survey to identify and prioritize the functional program areas that benefitted from revenue-sharing funds. For those cities that listed capital improvements as their number-one priority, the 1972 and 1974 surveys found "parks and recreation" to be far and away the leading target of capital spending, with "public works" second and "public safety" third. But by 1984 and in 1988, "public works" was the leading choice, with "public safety" second; "parks and recreation" was ranked first by only one city in 1984 and two in 1988.

Open-ended responses to the more recent surveys suggested roads, bridges, and water and sewer treatment to be the leading candidates for public works projects. Correctional facilities and some police and fire equipment were noted under public safety.

Massachusetts offers an example of how funds could have been used. The Massachusetts Water Resources Authority was facing a $4 billion cleanup of Boston Harbor, to be paid primarily by residents and businesses that discharge effluents into it. The fear was that water rates would double for both, raising annual water bills to the level of annual property taxes, and putting Boston area businesses at a competitive disadvantage. Carol Browner, head of the Environmental Protection Agency, noted that every $1 billion spent on sewer projects generates 50,000 jobs (Scott 1993).

Past president of the U.S. Conference of Mayors, Boston's Ray Flynn, reported $92.7 million in capital projects ready to go, which his administration estimated would generate 4,000 permanent private-sector jobs (many involving recycling).

LESSONS FROM REVENUE SHARING

The early, consistent, and surprising use of federal general revenue-sharing funds for capital improvements is evidence that unrestricted federal aid stimulates state and local public investment.

The data reveals that cities have had to cut back or postpone their capital-improvement projects due to the loss of federal funds. The survey responses were remarkably consistent within each survey. In response to questions involving different revenue scenarios (new federal aid, new local tax, expanded tax base), the leading potential use of the new revenue was always capital expenditure. The desire for more public investment was also consistent over time.

It appears that for local chief executives, sound fiscal policy matches good electoral politics and thus may help produce effective intergovernmental policy. Local officials were extremely cautious with the use of revenue-sharing funds, realizing that any potentially short-term, unrestricted aid was best spent on non-recurring expenses. New hires were to be particularly avoided, as the political harm of layoffs is high. Property tax reduction may be pleasing in the short run, but it can cause political damage later when rates have to be raised to make up for lost funds and cost increases.

It is also important to note that this study analyzed the uses of federal funds that were unrestricted. That is, with absolutely no direction from the donor, cities still found capital improvements to be their predominant priority. A program of restricted federal aid for infrastructure development could require specific applications and an audit; these requirements would probably increase the already strong inclination of local chief executives to undertake capital projects. The evidence presented here suggests that the extra costs of restricting aid may not be necessary in the case of local revenue sharing. Fears of tax substitution and payroll padding appear to be unfounded.

The current dynamics of local budgeting point strongly to the likelihood that unrestricted intergovernmental aid would promote local public capital-improvement purposes. If federal policy makers seek a fiscal stimulus to boost current rates of employment, and if they also uphold the importance of public investment in private-sector productivity growth, then a new program of general assistance to local governments merits strong consideration.

May 1996

ENDNOTES

1. Categorical grant funds must be spent on purposes designated by the donor government, with some cost of the program shared by the recipient. Thus categorical grants may "distort" local preferences, encouraging spending (both of federal funds and local matches) on the designated item.

2. The 1978 voter-passed Proposition 13 lowered average property taxes from an approximate average of 2.7% to 1%, and constitutionally mandated that they stay at 1%, and that assessment not be allowed to increase by more than 2% per year. Any override or new tax increase required approval by a two-thirds vote of local residents. Obviously Proposition 13 placed severe restrictions on the ability of local government officials in California to raise revenue.

3. The participant-observer approach involves actively participating in the decision-making process, sometimes as an employee of the government under study.

BIBLIOGRAPHY

Break, George F. 1980. *Financing Government in a Federal System.* Washington, D.C.: Brookings.

Caputo, David A., and Richard L. Cole. 1977. "General Revenue Sharing: Its Impact on American Cities." *Government Finance* (November), pp. 24-33.

Crecine, John P. 1969. *Government Problem Solving: A Computer Simulation of Municipal Budgeting.* Chicago: Rank McNall.

Larkey, Patrick. 1979. *Evaluating Public Programs: The Impact of General Revenue Sharing on Municipal Government.* Princeton, N.J.: Princeton University Press.

Meltsner, Arnold J., and Aaron Wildavsky. 1970. "Leave City Budgeting Alone! A Survey Case Study and Recommendations for Reform." In John P. Crecine, ed., *Financing the Metropolis: Public Policy in Urban Economics.* Beverly Hills, Calif.: Sage Publications.

Oates, Wallace. 1972. *Fiscal Federalism. New* York: Harcourt Brace.

Office of the Mayor, City and County of San Francisco. n.d. "General Revenue Sharing Preliminary Program." *Policy Guidelines,* mimeo.

Public Management. 1973. "Implementation of Revenue Sharing." Editorial, Vol. 55, No. 1, p. 21.

Pressman, Jeffrey. 1975. *Federal Programs and City Politics.* Berkeley, Calif.: University of California Press.

Scott, Alan. 1993. "U.S. Is Lobbied to Hike Harbor Cleanup Aid." *Boston Globe.* February 4.

U.S. Advisory Commission on Intergovernmental Relations (ACIR). *197* 1. *Measuring the Fiscal Capacity and Effort of State and Local Areas.* Washington, D.C.: U.S. Government Printing Office.