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Winter/Spring 1986, Vol. 12, No. 1/2

PERSPECTIVE



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(March 1986)

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In This Issue . . .

The topic of welfare reform has once again been propelled to the forefront of public debate. In this issue of *Intergovernmental Perspective*, "Welfare Reform: The Search for Consensus", we present articles based upon the statements of three witnesses, and highlights from the comments of eight others, who testified at an ACIR public hearing on February 5 in Washington, D.C. This hearing, and others to be held throughout the year, are one component of a major welfare study initiated by the Commission early last year. . . . The discussion surrounding the deductibility of state and local taxes from the federal income tax continues in our "point-counterpoint" feature. . . . A description of the Canadian experience with the Representative Tax System (RTS) provides another look at alternative measures of tax capacity and tax effort. . . . Our "Fiscal Note" presents ACIR's preliminary estimates of changes in 1986 federal income tax liabilities, by income class, under the President's and the House-approved tax reform proposals. . . . The "Intergovernmental Focus" feature spotlights the Tennessee ACIR. . . . And the "ACIR News" and the "And Briefly: Books" sections bring you up-to-date on recent Commission activities and publications.

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President Announces ACIR Appointment

Daniel J. Elazar, Director of the Center for the Study of Federalism at Temple University in Philadelphia, has been appointed by President Reagan to be a member of the Advisory Commission on Intergovernmental Relations. He will serve a two-year term.

Elazar is an internationally recognized scholar on federalism. He edits *Publius: The Journal of Federalism*, is President of the Association of Centers for Federal Studies, President of the Jerusalem Center for Public Affairs, and has written and edited numerous publications. He is a former Guggenheim Scholar, Fulbright Senior Scholar, and the recipient of grants from the Ford Foundation, the National Endowment for the Humanities, and the National Science Foundation.

Farm Economy Study Underway

At the request of Senator David Durenberger (MN), the ACIR staff is preparing a report on the agricultural recession's impact on state and local government for the Senate Subcommittee on Intergovernmental Relations. A progress report will be presented to the Commission at its April 18 meeting.

The staff report will identify the intergovernmental issues that the newly-constituted National Advisory Commission on Rural America should address as part of its overall evaluation of the rural economy. Particular attention will be devoted to both the current trends in state-local aid flows and to indicators of fiscal stress.

Welfare Reform Hearing Slated For April 18

The second in a series of ACIR public hearings on welfare reform will be held on Friday, April 18 in Washington, D.C. The hearing series is one component of a major welfare study that was adopted as part of a comprehensive research agenda by the Commission in March of last year.

Among the topics to be considered during the course of the study are: the merits and demerits of national minimum benefit standards; the advantages and disadvantages of workfare; the effects of welfare on families; and the varying capacities of the states to deliver welfare programs and services. A broad range of witnesses will participate in the hearings, including federal, state and local officials; political scientists, economists and sociologists; and other experts in the general field of welfare.

ACIR Research Focuses on Judicial Federalism

ACIR staff have begun a study of the merits and limitations of federal court involvement in state affairs. Many observers assert that the states' position in the federal system has been altered substantially during the past 50 years through federal court decisions.

The first phase of the project has been completed, and a report entitled *A Framework for Studying the Controversy Concerning the Federal Courts and Federalism* has been published. This report outlines the scope, direction and issues which require consideration in studying the role of federal court actions.

Future research will focus on policy areas where judicial involvement has attempted to reform state and local institutions, and data will be collected on the consequences of judicial decisions on the quality of public policy and the values of federalism. Additional studies will deal with key issues of constitutional design, the legal basis of federalism, and the role of contemporary legal doctrines in federal court decisionmaking.

Commission Meeting Set For April 18

The Spring meeting of the Advisory Commission on Intergovernmental Relations will be held on Friday, April 18 in Washington, D.C. Highlights of the business agenda include:

- a progress report on the study of the fiscal effects of federal income tax reform on state and local governments;
- a status report on a study of the farm recession's impact on intergovernmental finance;
- preliminary findings from a research project analyzing the role of fiscal discipline mechanisms in the federal system; and
- a discussion of future directions for the national/state ACIR partnership.

GOVERNMENT FINANCE DATA ON MICROCOMPUTER DISKETTES

Many public finance analysts are familiar with the wealth of information published annually by ACIR in *Significant Features of Fiscal Federalism*. Now, for the first time, much of the state and local revenue and expenditure data in *Significant Features* are available on MICROCOMPUTER DISKETTES. All of the data are drawn from the Bureau of the Census annual governmental finance series. Population and income data also are included.

Although many publications (including *Significant Features*) contain a vast array of state-by-state comparisons, they do not allow users the flexibility to compute and display the data in other forms. The spreadsheets on the diskettes developed by ACIR provide access to the Census data in a format not previously available, facilitate manipulation, and reduce the computational burden.

Any microcomputer that is compatible with an IBM-PC and has a minimum of 256k RAM will work. While designed for use with LOTUS 1-2-3 and Symphony software, any spreadsheet program will work by using the appropriate "translate" utility program that is an integral part of most software.

The diskettes will be of considerable use to legislative and executive staff, public finance analysts, and others who wish to make interstate comparisons of government revenues or expenditures, or who need ready access to the Census governmental finance data. State-by-state data for 70 expenditure and 66 revenue classifications, and population and personal income are available for:

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Intergovernmental Focus

Spotlight on the Tennessee ACIR

Harry A. Green
Executive Director
Tennessee ACIR

A recent first-ever event highlighted the Tennessee connection with the U.S. Advisory Commission on Intergovernmental Relations. Representative John Bragg, a prominent Tennessee legislator and immediate past president of the National Conference of State Legislatures, was appointed to the ACIR. The uniqueness of this appointment is that Representative Bragg is the only person to serve actively on a state and the national ACIR simultaneously. He has served for eight years on the TACIR, was its first chairman, and currently serves as vice chairman.

However, this only highlights the Tennessee connection. Over the years, several Tennesseans have served on the national ACIR, one of whom served two appointments separated by ten years. Moreover, Tennessee appointees to the ACIR have represented most of the membership categories: two governors; one mayor; one county executive (served two separate terms); one U.S. Senator; one private citizen; and one state legislator.

Currently, another Tennessean serves on the ACIR: U.S. Senator James Sasser has been a member for seven years. Moreover, Tennessee's incumbent chief executive, Governor Lamar Alexander, served as vice chairman of ACIR until 1984, when his duties as chairman-elect of the National Governors' Association required him to resign.

The Tennessean who served two separate terms on ACIR is Judge William O. Beach—the current chairman of TACIR. Judge Beach is the former County Executive and Criminal Court Judge of Montgomery County, and served his first term on ACIR during the

period of 1966-68 and his second during 1978-80. Judge Beach is also unique in that he has served in two different capacities with our state ACIR. First, Judge Beach became a member of TACIR by virtue of his position as president of the Tennessee Development District Association. When Judge Beach retired as a county official, Governor Alexander appointed him as a private citizen member. Judge Beach was elected chairman of TACIR in 1981, and has been re-elected to that position since that time. Judge Beach also has served as president of the National Association of Counties and president of the National Association of Regional Councils.

Other prominent Tennesseans who have served on the national ACIR are the late Governor Buford Ellington, the late Mayor Beverly Briley (Metro Nashville); and Alexander Heard, former Chancellor of Vanderbilt University.

TACIR: The Beginning

In 1977, the General Assembly abolished the Advisory Commission on Intergovernmental Cooperation and created in its place, the Tennessee Advisory Commission on Intergovernmental Relations. The Commission on Intergovernmental Cooperation had been languishing for a number of years, and this legislative action represented a significant change in emphasis.

As it was established, TACIR is a permanent, independent and bipartisan commission. The members include local officials, state executive officials, members of the General Assembly, and private citizens. Originally, the Commission had 21 members, but the

number was increased first to 25 members and later to its current level of 29 members.

Among the major duties of TACIR, the following are most important:

- to serve as a forum for the discussion and resolution of intergovernmental problems;
- to study and evaluate the current pattern of governmental structure and its viability for the future;
- to study and evaluate the existing and desirable allocations of state and local fiscal resources; and
- to report all findings and recommendations for change and improvement to the Governor, General Assembly, the general public, and all interested citizens.

Under this broad umbrella of function and responsibility, there are few areas of public policy that are inappropriate for TACIR attention.

Priorities and Accomplishments

TACIR was given life during the fiscal year 1977-78. However, it was not until four years later that it was given funding to hire its own staff. During the period 1978-81, it became clear that the role and mission of TACIR was too important to depend on "loaned executives" and the budgetary goodwill of other agencies.

Three important things happened in 1981 to launch TACIR effectively on its mission. First, in recognition of anticipated changes in federal policy and funding, the General Assembly approved an appropriation to fund TACIR. This was extraordinary because the proposal was not originally part of the executive budget. Secondly, the

TACIR statute was amended to expand the membership to make it more representative. Thirdly, the General Assembly passed a resolution directing TACIR to conduct a study of President Reagan's proposed "New Federalism" and its potential impact on state-local functions and funding.

Early on in its deliberations, the Commission adopted a futuristic orientation in the pursuit of its goals and responsibilities. However, this futuristic orientation was conditioned by a constructive pragmatism relating to specific issues. Recognizing that changes in federal funding inevitably would increase the stress on local funding—and the property tax in particular—the Commission decided to conduct a comprehensive study of the property tax in Tennessee. During the next two years, the Commission conducted public hearings, reviewed staff studies, and deliberated about property tax reform. Eventually, a number of recommendations were made and several have been implemented. Among the changes proposed were property tax equalization among taxing districts, improvement in the conduct of appraisal ratio studies, computerization of assessment procedures, more frequent reappraisal, and the development of a current value index to maintain property value at full market value.

Other issues on the TACIR agenda are funding for indigent health care; a review of equity and adequacy in street, road, highway and mass transit finance; the distribution formulas for state-shared taxes; equity in school finances; and the structure and function of local governments in Tennessee.

Soon after its initial funding, Governor Alexander addressed the TACIR membership, and outlined his views about the proper role of the Commission, and emphasized three major responsibilities:

- collect and analyze data;
- prepare and distribute reports based on that data and analysis; and
- play a leading role in the reformation of state-local relations, finance and state-local governmental structure.

The Commission has actively pur-

sued these responsibilities and finds that its role is growing. This growth is due to the changes in federal-state relations, and because of the increasing recognition that TACIR is an appropriate body to study and deliberate on changing state-local relations.

TACIR has published 45 different reports and bulletins, and has prepared numerous unpublished reports on limited selective policy issues. As an indication of its concern about local fiscal relations and tax equity, the Commission has published 11 different reports and

bulletins on the property tax.

In addition, the Commission has held 24 official meetings plus a number of special committee meetings. Currently, TACIR is working on the following ten policy areas, on which it plans to make recommendations for change:

- A consistent uniform policy for tax equivalent payments by municipal utility systems
- A current-value index proposal that could save millions of dollars in property reappraisal costs and improve tax equity

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 Colonel James Norwood, Cookeville
 Mr. Thomas E. Settles, Nashville

- An equitable, responsible and reasonable approach to the financing of indigent health care
- An evaluation of "possessory interest taxation" and its potential impact in Tennessee
- An evaluation of disparities in per pupil expenditures among the state's school systems
- An evaluation of an appropriate methodology for the measurement of local fiscal ability and fiscal effort
- An evaluation of equity and efficiency factors in state-local shared taxes
- An evaluation of equity criteria for the distribution of shared motor fuel taxes
- An evaluation of the powers, functions, patterns and responsibilities of local governments in Tennessee
- An evaluation of the impact of changes in federal policy and funding on state and local government in Tennessee.

The TACIR Concept

The membership of TACIR is one of its most significant features. Many important policy makers serve on the Commission, and this improves its role as a forum for the discussion of intergovernmental policy. For example, the respective chairmen of the House and Senate Finance, Ways, and Means Committees are *ex-officio* members. In addition, two other legislators—one from the House and one from the Senate—are long-term members of the respective finance committees. Moreover, the other important financial officers of the state—the Commissioner of the Department of Finance and Administration and the Comptroller of the Treasury are *ex-officio* members.* In addition, the leadership of each major sector of local government is represented on the Commission, as well as important private citizens. This serves to support and underscore what is probably the most important function of the Commission: to serve as a forum for the discussion and resolution of intergovernmental problems and issues.

*All TACIR *ex-officio* members have full voting rights.

Representative Bragg, a strong supporter of the ACIR concept, recently observed that "the most important thing that any state can do at this juncture of the evolution of American federalism is to create an ACIR. It is the only type of institution that provides an objective forum for the resolution of critical state-local issues that will shape our future. I urge every state with-

out an ACIR to create one, and for those states that already have them, I recommend that they be strengthened."

In the words of TACIR Chairman Beach, "the importance of the Advisory Commission is so great to our future capacity to govern, that if it did not exist, we would have to invent it."

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Federalism and Welfare Reform

Daniel J. Evans

I would like to commend ACIR for its focus on welfare reform. I believe it is a timely discussion because an effective welfare system can only emanate from an effective federal-state partnership. Next year—1987—will mark the beginning of the bicentennial of our Nation's Constitution. It is the hallmark of our free society, providing guarantees of fundamental rights and a blueprint for sound government organization. As we prepare to celebrate the Constitution's 200th anniversary, it is appropriate that we reassess the effectiveness of our intergovernmental relationship. Therefore, a renewal of the federalism debate is essential to the continued well-being of our system of government.

New Federalism Report and Recommendations

In 1984, the Committee on Federalism and National Purpose was convened under the auspices of the National Conference on Social Welfare's Project on the Federal Social Role. The committee, which I had the privilege of co-chairing with Governor Robb of Virginia, was comprised of representatives from all levels of government, having broad and diverse viewpoints. Recently, the Committee issued a report on federalism which represents a bipartisan and well-reasoned plan to renovate our system of government.

At the root of all the ills plaguing our system of federalism is the irrational and illogical nature of intergovernmental relationships. In addition to this nonsensical organization, there is a fundamental lack of trust among various levels of government. Both symptoms have led to excessive regulations, duplication of efforts, and a convoluted division of responsibilities. Instead of recognizing the new and advanced capabilities of state and local governments to administer programs requiring individual services, the federal government has maintained a heavy and burdensome presence.

The appropriate role for the federal government is to maintain a commitment to fundamental needs requiring national uniformity. At the same time, it should relinquish control of responsibilities best executed by the states. In pursuit of this goal, the Committee made various recommendations to improve the effectiveness of federal welfare programs. I would like to review them briefly.

The consequences of an illogical intergovernmental structure are readily apparent in our present welfare system. The growing economic vulnerability of the poor is aided in large part by the unfairness of our income support programs. The current inequities in AFDC are disgraceful. In January 1985, the maximum AFDC grant for a family of three was \$555 in California and \$118 in Alabama. To be poor and hungry in New York, however, is not much different than being poor and hungry in Mississippi, Maine or Missouri. In some states, eligibility ends when family income exceeds 49% of poverty level income. Yet, in other states, it extends to families with incomes equal to or above the poverty threshold. In 25 states, families containing both parents are not eligible for AFDC, or for that matter, any federal cash welfare benefits, no matter how destitute they may be.

To eliminate these benefit inequities, the Committee recommended that the federal government establish national minimum benefit levels and eligibility standards for the AFDC and medicaid programs. A national benefit floor should be established and maintained for AFDC and food stamps which is between 75% and 90% of poverty-level income.

The Committee also recommended that the federal government assume full policy responsibility for AFDC and medicaid as well as 90% of the financial responsibility of the minimum benefit levels. States should maintain administrative responsibility for these programs. In addition, more emphasis should be placed on state administration of employment programs supporting AFDC by expanding education,

training and placement activities. The welfare system, to the maximum extent possible, should be a jobs system.

The anticipated rapid growth of the Nation's elderly population will bring with it new demands for the provision of long-term care. Although medicaid provides these services, they are offered in the same way as acute medical care. Our failure to recognize the difference has created an over-reliance on nursing homes and hospitals, instead of encouraging use of less costly and more humane alternatives such as home care and community support services. Therefore, to promote more cost-effective and efficient service delivery, the non-medical component of long-term care should be separated from the rest of the medicaid program. This segment should be converted into a federal block grant to states, indexed for changes in the program's cost and the population it serves.

While the federal government assumes greater policy and financial responsibility for AFDC and medicaid, it should devolve other areas to state and local governments which is an essential element in this new partnership. I am reminded of Alexis de Tocqueville's observation of the dire consequences of "combining centralized government with that of centralized administration; uniting the habit of executing its commands to the right of commanding; and establishing the general principle of government and descending to the details of their application . . . freedom would soon be banished from the New World."

Specifically, states and localities should assume full financial, policy and administrative responsibility for many community development, local infrastructure, and social service programs. Thus, the more than 200 remaining intergovernmental programs funded by the federal government at less than \$100 million either should be consolidated into block grants or absorbed into existing programs. The remaining shared programs should be directed more toward localities with the most need. To accomplish better targeting of resources, more reliance should be placed on states. A relationship with greater dependence on states will foster more trust. Thus, we should use incentives rather than sanctions to hold states and localities accountable for program administration.

In order for states to meet their present and future service obligations, the federal government should provide general support grants targeted to states with low fiscal capacity. Until the effects of devolution can be assessed adequately, a transitional federal assistance program should be established and administered by states for localities with the least fiscal capacity.

Implementation

It is important to emphasize that these recommendations are intended to be a comprehensive package, implemented together. Also, it should be acknowledged at the outset that proper and effective reform will take several years. With the critical demands of deficit reduction, accomplishment of these objectives must be, at a minimum, revenue neutral.

I do not believe that the need to eliminate unacceptable federal deficits in the Gramm-Rudman envi-

ronment hinders new federalism reform. Rather, I believe it has provided us with a window of opportunity. Gramm-Rudman will require reassessment of our basic commitments to find more cost-effective means for targeting and delivery of less federal resources. Implicit in Gramm-Rudman, however, is a framework for new federalism in the continuing federal commitment to major income assistance programs. For example, among the programs exempted from sequestration are AFDC, medicaid and food stamps. Therefore, I believe federalism reform is an essential element of establishing and maintaining principled Gramm-Rudman policy, requiring ultimate goals and immediate first steps.

In an effort to maintain a focus on new federalism in the Gramm-Rudman process, I intend to introduce a concurrent resolution committing us to the deficit reduction targets in Gramm-Rudman and calling for the budget and policy decisions in reaching these targets to be consistent with the new division of intergovernmental responsibilities called for in the Committee's report. There are several other legislative steps I will take to keep this debate alive in 1986.

Recently, Senator Dave Durenberger (MN) and I introduced legislation to establish a Targeted Fiscal Assistance program. Under this proposal, general purpose grants would be available to local governments, allowing local officials and citizens to determine how best to use such funds. An interstate formula would determine each state's allocation. By utilizing appropriate measures of need and fiscal capacity, the program will target funds to those communities with the greatest needs.

Reform of federal quality control in AFDC, medicaid and food stamps is another area of critical importance to a sound and stable intergovernmental partnership. The existing system illustrates most vividly the major shortcomings in the federal-state partnership, for it is a system premised on distrust. The current practice of imposing punitive sanctions against states for errors in program administration does not help them become better program managers—which should be the real objective of quality control. Instead, it has exactly the opposite effect. Not only do large fiscal penalties place undue strains on already-sparse state resources, but they hurt the very people the programs are intended to serve. We were successful last year in initiating a major study of the food stamp program and a temporary moratorium on penalty collections; however, much more needs to be done. Therefore, I will continue to push for comprehensive reforms in federal quality control for AFDC and medicaid.

Our long-term focus is on developing major proposals for a greater federal role in AFDC and medicaid and a block grant program for long-term care under medicaid. The key element in this effort is to provide for a trade-off between federal and state governments that is both fair and revenue neutral. In some areas, it may be possible to have more than a dollar-for-dollar trade-off; for example, for every \$10.00 the federal government relinquished, states may be able to pick up \$12.00 or \$13.00. The primary financing method for devolution would be the fiscal dividend gained from federalization of welfare programs.

Conclusion

In conclusion, I believe a renewal of the federalism debate is essential. As we move forward, we should remember the words of de Tocqueville when he observed, "a centralized administration is fit only to enervate the nations in which it exists, by incessantly diminishing their local spirit. Although such an administration can bring together at a given moment, on a given point, all the disposable resources of a people, it injures the renewal of those resources. It may ensure a victory in the hour of strife, but it gradually relaxes the sinews of strength. It may help admirably the transient greatness of a man, but not the durable prosperity of a nation." Thus, it is critical that we take great care in our efforts to unite policy-making with implementation in reshaping the federal role.

Our founding fathers envisioned a shared system of government with a logical and productive division of responsibilities. It is time that we reexamine the federal-state partnership and make necessary improvements to ensure its continued vitality. I can think of no better bicentennial birthday present for this nation in 1989 than to reestablish the essential partnership between states and the union that gave birth to our Constitution.

Daniel J. Evans is a U.S. Senator from the State of Washington. A former governor from that state and president of Evergreen State College, he served as a member of ACIR from 1973 to 1977.

Public Welfare Reform Issues

William G. Colman

When the recommendation to nationalize AFDC and Medicaid financing was adopted by the ACIR in 1969, I personally favored it strongly. In 1971, I was also strongly in support of President Nixon's initiative along similar lines. By the mid-1970s, I had concluded that such a step was fiscally unwise, because of the wide disparity among regional living costs and the apparent unwillingness of the Congress ever to agree to incorporate regional or other cost differentials into financial transfer programs to individuals.

In recent years it also has become apparent that if welfare dependency and its relative permanence in a substantial proportion of recipients is to be lessened, a range of state and local programs and support services must be re-directed in such a way as to enhance the transfer of individuals from welfare rolls to payrolls especially in private sector employment. The close relationship between welfare rolls and state-local programs for private sector job training, remedial education, subsidized day care, and other social services is a formidable consideration in the allocation of financial and administrative responsibility for public assistance in the United States. If all or most of the cost of AFDC

was assumed by the federal government, energy and resources at state and local levels now directed toward re-orienting welfare toward *employment*—in contrast to income maintenance—might be expected to falter and decline, because the fiscal pressures for change would no longer be felt as strongly as at present.

"Limited Swaps". I think there are strong arguments for the kind of swaps suggested by the Committee on Federalism and National Purpose in its recent report, *To Form A More Perfect Union*. However, such swaps should approach revenue neutrality, with net reductions on the state-local side to approximate fiscal savings achieved through grant consolidation. I think the Committee's figure of a federal share of 75% to 90% of AFDC, Medicaid and food stamp programs is too high, and as indicated later, interstate differences in living costs argue against uniform minimum benefit levels across the nation.

I think the most important sentence in the welfare section of the Federalism Committee's report is: "To the maximum extent possible, welfare systems should be converted into job systems." The financial dimensions of the Administration's catastrophic health cost proposal need to be assessed in terms of extent of state fiscal relief from part of long-term nursing home care costs.

Intergovernmental responsibility for financing and administration. In general, (1) the present welfare system needs to be replaced with a job placement-oriented system that encompasses existing state-local general assistance, as well as AFDC recipients; (2) Medicaid should operate as at present, as a needs-based medical assistance program, with economic eligibility based on standards similar to those for obtaining *transitional* income support under the reformed welfare system; (3) whatever increases are effected for federal welfare and medical assistance outlays should be offset by fiscal reductions through transfers of full financial and policy responsibility to the states for selected categorical grants; and (4) administrative responsibility for welfare should be further devolved to the states, including the decategorization of the present system, with the new program covering a portion of defined outlays for economically needy persons under 65 years of age.

Emphasis on workfare. As indicated earlier, the new system should be oriented to job training and job placement. Several promising initiatives are already underway, especially in California, Massachusetts, Oregon and Maryland. An ACIR draft state legislative proposal, entitled "Comprehensive Employment Training, Placement and Relocation Assistance Act", developed in 1984 as part of the Commission's report on states and distressed communities, contains a Title V: "Employment and Training of Public Assistance Recipients and Disadvantaged Youth." It contains a series of alternative program approaches to the workfare issue. It should be kept in mind that subsidized day care, at least during the training and placement period, is a

necessary component of most successful efforts to move recipients off welfare rolls into full-time employment.

Safety net for low fiscal capacity states. The provision of a safety net depends upon the way a block grant for welfare and associated purposes is structured, and especially on the matching or reimbursement formula and on the extent that minimum and/or maximum benefit levels for federal participation are specified in the legislation. It is also dependent on whether a welfare/Medicaid swap involves state assumption of full fiscal responsibilities in other fields now federally aided in larger or lesser proportions.

The sharp decline in petroleum prices, the resurgence of the New England and New York economies, and other economic shifts appear to lessen considerably the justification for a national fiscal capacity equalizing program. As suggested below, any national minimum welfare benefit level perhaps raises more problems than it resolves; benefit levels in a state rest on an amalgam of considerations—relative state-local fiscal and administrative responsibilities for particular functions, priorities among competing needs, and differing values and policies of tolerating or discouraging long-term welfare dependency on the part of employable persons.

National eligibility and benefit standards. One or more broad national standards of eligibility are both necessary and desirable (e.g. economic need—as determined by a state—and below 65 in age). Any national definition of need must be related to state income and other relevant statistics for states or individual metropolitan areas and not to national averages, and must allow state differentiation based on price levels and costs of living differences within the state. Unless a national benefit standard provided wide flexibility, it would probably turn out to be unduly costly and unacceptably inequitable.

Has the welfare system helped or hurt the poverty populations? On balance, and despite its many failures, federal aid for public assistance has substantially helped the needy people of America by removing the county poor house from our society and otherwise lessening the social gap between the economically unfortunate and the rest of the community. Secondarily, federal welfare aid over many years helped provide, along with SSI and Social Security, a needed floor for the economies of low income states. As interstate economic and fiscal disparities continue gradually to abate, this aspect of federal welfare aid diminishes in importance.

Relative governmental efficiencies in welfare administration. In defining “welfare programs,” for purposes of this question as a combination of AFDC and general assistance, state and local governments obviously are in a much better position to administer a reformed structure of such a combination than is the national government, because the variety of related and supporting services—vocational education, adult literacy training, specialized occupation-specific train-

ign for private sector employment, day care, enforcement of workfare provisions, etc.—all are administered and financed largely or totally by state or local government. Unless we are to have an automatic pilot type of means-tested *entitlement* program along the lines of SSI, with no particular objective of relating the program to goals of self-sufficiency and full-time, permanent employment, then primary responsibility for administration of, and significant financial responsibility for, the program must be lodged with state governments.

A work-oriented welfare program requires a state-local, not a national, context because the federal government is not in a position to establish a welfare office of its own in every county and large city in the United States. In contrast to SSI, AFDC and general assistance recipients are either in or about to enter the educational system or are members of the potentially available labor force, not being disabled or elderly. Fortunately, many earlier restrictions upon state actions in the poverty area have been removed or substantially modified. If federal regulations continue to inhibit states from the enactment of relative responsibility or lien-recovery legislation, then such regulations should be re-evaluated.

Improved targeting of means-tested anti-poverty programs. Lien-recovery and relative responsibility laws where such do not already exist would conserve resources appropriated to poverty relief, as would further modification of Medicaid legislation and regulatory controls to permit more home care, although some of the more counter-productive federal requirements in this regard have already been modified.

Splitting financial and administrative responsibilities. As indicated earlier, financial responsibility for welfare needs to continue to be divided between federal and state governments. Primary responsibility for administration needs to be vested in the states, because all of the public support services associated with welfare as enumerated earlier have their roots in state law.

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The New Era in Welfare Reform

Leslie Lenkowsky

On February 4, President Reagan joined every president since John F. Kennedy in calling for an effort to change fundamentally the American welfare system. Each denounced the existing public assistance programs as a "disgrace," a "mess," a "narcotic," or worse. Each sought to achieve similar goals: to offer better help to the needy, to reduce dependency, to strengthen the family. And so far, none has succeeded.

Whether or not President Reagan will be able to triumph where his predecessors have failed remains to be seen. He faces a number of obvious disadvantages: a far larger and more complex set of programs, a budgetary outlook that permits no additional spending, a poverty level that is near a 20-year high. Each of these makes solving the welfare problem more compelling—and more difficult.

However, President Reagan also has at least one great advantage over his predecessors. Although fundamental changes have not occurred, the past 20 years have not been fruitless for welfare policy. We have observed, we have experimented, we have learned. Perhaps not as much as we would have liked; certainly much more than when we began. Moreover, despite what often appears like a loud statistical cacophony, most of the research on poverty and dependency is remarkably consistent. Properly understood, it offers considerable aid in fashioning a new proposal for welfare reform.

Let me review briefly the key findings and then sketch what I take to be their implications for public policy, and particularly for the roles of federal, state and local governments in providing public assistance.

Poverty

Two decades ago, a major impetus for reforming the welfare system was to reduce poverty. Despite a growing economy and new education, employment and community development programs, millions of Americans were poor. Many seemed likely to stay that way, since, being old or very young, they were effectively outside the labor force. The existing welfare programs did not seem up to the job of raising their incomes to minimal standards, since benefit levels varied widely from state-to-state and almost nowhere did they come close to the poverty line. Hence, reformers sought to increase the amount of money that was provided or even establish a national "floor" for public assistance. This was known as the "income strategy."

The proportion of the American population that is poor is not much different now than it was in the mid-1960s. However, we now have a much clearer picture of who the poor are and why they are in poverty. And contrary to our earlier impression, we know that most of the poor do not stay poor very long.

According to a number of studies, the best known of which was done at the University of Michigan, the poverty population is remarkably fluid. Over an extended period of time, such as a decade, a relatively large number of Americans—approaching 25%—are likely to be poor at one time or another. Most of them do not suffer this hardship for more than a brief period of time, while only a tiny fraction—approximately 3% of the population—are poor persistently.

In other words, if one were to track all the people who *fell* into poverty today, one would find that a large number of them were no longer poor a year from now and fewer and fewer remained in poverty each subsequent year. Yet, if one looked only at those who *were poor today*, a sizable proportion would be found to have been in poverty for quite some time.

These findings do not imply that employing an "income strategy" is unnecessary. To the contrary, for the portion of the population that is persistently poor, it may be the most useful way of providing help. And even the temporarily poor may derive some benefit from public assistance programs. However, the more significant implication is that a hike in benefits, or a national floor, will not be essential for most of the people who become poor. Thus, these objectives may not be as important for welfare reform as they used to seem.

Dependency

This judgment is reinforced by what we have found out about the relationship between public assistance benefits and welfare dependency.

Twenty years ago, one of the problems of the existing programs seemed to be that they offered no incentive to

work. For each dollar a recipient earned, a dollar in benefits was taken away. Not surprisingly, many experts concluded that this formula encouraged those who could work to remain on relief, rather than try to become self-supporting.

The "thirty and one-third rule" adopted in the *Social Security Amendments of 1967* was supposed to change that. It enabled recipients to retain a portion of their earnings without losing any benefits. This financial incentive was buttressed by a variety of administrative rules, training requirements, and job-creation schemes. Together with similar provisions built into other welfare programs, they were expected to cause welfare dependency to decline.

Nothing of the sort happened. The size of the caseload for Aid to Families with Dependent Children (AFDC) has not changed much since 1972—the number of families has actually gone up—and we now have a good idea why. Any incentives for self-support created by the various reforms were more than offset by the dependency-producing effects of the income available through public assistance.

This relationship has been established in several ways. Looking at differences among states, a number of researchers have concluded that higher benefits have reduced the hours worked by welfare mothers. Using longitudinal data on family incomes, other scholars have reported that women were less likely to work their way off AFDC in states that provided higher benefits. The negative income tax experiments revealed that income guarantees produced a significantly greater drop in effort among recipients than among a control group. The decline was especially pronounced among wives and female heads of families.

Although these studies often disagree about the magnitude of these effects or their significance, they all confirmed that public assistance provides an attractive alternative to low-paying employment, especially for women. Indeed, adding financial incentives was as likely to enable recipients to remain on the welfare rolls as to work their way off. Training and employment programs rarely improved matters.

Of course, the new "workfare" projects underway in about half the states might possibly show better results. The evidence is not yet in. However, the experience of the last two decades is thin on encouragement. Most of what it tells us is that welfare programs are far more adept at increasing dependency than other measures are at reducing it.

Family Stability

More surprising, and more alarming, is what we have learned about the effects of public assistance on families. Starting with President Kennedy, this has been a concern of every effort at welfare reform. Many experts have argued that since AFDC was usually available to single-parent households, it contained an incentive for families to dissolve (or never to form), thus lowering their standard-of-living and increasing

the likelihood of long-term poverty and dependency. However, there was little evidence on the point and much disagreement.

Now, we know more and while there is still considerable argument, it is mostly over interpretations rather than data. No matter what methods they used, researchers have generally found that AFDC does have a significant influence on family stability. Comparing data from states or cities that give different amounts of public assistance, several scholars have reported that higher welfare benefits raised the proportion of female-headed families. On the basis of interviews with recipients, another group of researchers found that in at least one-fifth of the cases, the availability of AFDC was instrumental in the decision to break up the family. Using longitudinal data, two Harvard experts estimated that increasing welfare benefits by \$100 per month would produce a 15% upswing in female-headed households.

The most persuasive evidence comes from the negative income tax experiments. They demonstrated that income guarantees would lead families to dissolve more often than comparable families in a control group. Indeed, the differences could be large, with family break-ups sometimes as much as 50% more common among the group receiving assistance than in the one which was not. Although these findings came from tests of a proposed alternative to the existing welfare system, they are consistent with other research on the impact of AFDC in those states (about half) which provide benefits to families where both parents are present. Whatever the rules of eligibility, public assistance really seems to serve as a kind of alimony for low-income women, enabling them to head their own households and raise their children alone.

No experts seriously dispute this anymore, but many do question whether AFDC has a causal role or merely a responsive one. Such scholars maintain that welfare mostly influences family composition by enabling single parents to live independently or to postpone remarriage, rather than inducing divorce or illegitimacy. Nonetheless, even if only responsive, public assistance reinforces whatever impels a woman to set up a family on her own. And for many women, that decision is an economically tragic one, drastically reducing their chances of attaining adequate living standards for their families.

Policy Implications

Knowledge does not always produce answers. While we have learned a great deal about welfare policy during the last 20 years, one might wonder whether we have come far in knowing what to do next. The case for a national floor seems somewhat weaker; the likelihood that an effective set of work incentives can be devised on a broad scale seems more remote. So long as we are unwilling to deny assistance to mothers and young children, the prospect of avoiding harm to the family seems problematic.

Welfare Reform: The

"The problem with any kind of swap at this time is that it will simply shift costs to the states and reduce the federal responsibility without affecting real reforms and changes. The urgency of federal budget reduction at this time does not lend itself to a well-thought-out program. . . . The elements of the basic swap, in which the federal government would assume more fiscal responsibility for assuring a basic level of welfare-Medicaid services, are still valid—they are just impractical and not achievable today."

—**Representative Jane Maroney, Delaware**
Chairperson, Human Resources Committee,
Council of State Governments' Eastern
Regional Conference

"The adoption of the Gramm-Rudman-Hollings Deficit Reduction Act will force state and local governments and the Congress to take a very close look at the gamut of federal assistance programs currently available to state and local governments, not just those that provide assistance to the poor. This is likely to be a painful and difficult project. However, this is the context in which welfare reform must be discussed. It will be difficult, if not impossible, to separate a restructuring of grant-in-aid to state and local governments and welfare reform. The magnitude of the task is overwhelming, though few of us would suggest it is unneeded."

—**Representative Thomas M. Marchant, III,**
South Carolina
Chairman, Health and Human Resources
Committee, National Conference of
State Legislatures

"Only the national government can significantly influence economic growth, the unemployment rate, the international trade balance, and consumer interest rates. These economic tools are beyond the reach of states. State governments cannot control the number of people seeking welfare benefits during a recession, and states cannot control the number of poor people residing within their borders. Common sense dictates that ensuring a healthy standard of living for our poor children is a national responsibility. But states simply do not want to shift more costs to the federal government without accepting comparable responsibilities that might be more appropriately addressed at the state level."

—**H. Louis Stettler, II, Secretary**
Maryland Department of Budget
and Fiscal Planning
President-elect, National Association
of State Budget Officers

"Clearly, there is no "quick fix" with regard either to the establishment of program parameters or to scarcity of resources. It is my opinion that the federal government should achieve its savings primarily by the reduction of its administrative costs and by allowing states more flexibility in administering their programs. We badly need consensus about a number of questions relating to the welfare system in the United States, but I am not of the opinion that merely swapping dollars or 'nationalizing' the AFDC/Medicaid components is a viable approach to achieve these goals."

—**Representative Jack C. Vowell, Texas**

Yet, such an assessment would be unduly pessimistic. The real lesson to be learned from the last two decades is not that welfare reform is hopeless but that the illusions we once held about it need to be abandoned. In particular, the idea that we could establish a "guaranteed income" for working-age families with children, which was as generous and efficient as Social Security, while promoting independence and family stability, should be laid to rest.

That does not mean that welfare reform is dead. To the contrary, for the last few years, it has been flourishing. And right where it needs to: in state, county and city governments.

If the research on welfare prompts any generalization, it might be that the solutions to the problems identified by every president since Kennedy can only be found locally. Only those who are sensitive to the particular conditions in which a family lives can know how much assistance is needed and for how long. Only by knowing who is ready to become self-supporting, and who is not, can one make training and employ-

ment programs succeed. Only by bringing to bear legal, social and moral suasion—that is, communal values—can parental responsibility for children be enforced. In other words, what is necessary for a successful welfare reform is not a new national program, but hundreds of new local ones.

From California to Massachusetts, such efforts have been springing up more frequently than anyone would have imagined several years ago. Not all are carefully developed; some may even be misguided; most have not begun to explore the opportunities they have at hand. They need to be encouraged, assisted, evaluated and expanded. For only out of such grassroots efforts will effective ways of dealing with the problems of poverty and dependency emerge. Moreover, without such efforts, federal goals could not be achieved.

One way of doing that is to change the incentives state and local governments have to improve their welfare programs. Under the current, open-ended matching formula, they "lose" money—their own—if they increase benefits and they also "lose" money—in this

Search for Consensus

"It is not likely that we will soon see a reordering of our system which appropriately places the financial responsibility for income security programs at the federal level. It is important, however, that we do not compromise our principles in the meantime, that we do not start making swaps. We should concentrate now on improvements in the current system. We should establish a national minimum benefit level. We should remove provisions which serve as a disincentive to work. We should assure that adequate employment and training assistance, along with necessary support services such as child care, are available to welfare recipients so that they will have a better chance at economic independence."

—**John J. Gunther, Executive Director**
U.S. Conference of Mayors

"The words 'welfare reform' are like an unforgettable tune of a musical. I find them always in my mind and frequently on my lips. Before reforming welfare, I'd like to see it prevented for most persons. The vast majority of people would never need welfare if we had some prevention programs in place. Welfare is often described as the safety net. It's a net that lays on a cement floor and people have to hit the floor before the programs offer help. Real safety nets would catch people before the damage of hitting the floor: adequate salaries for women; an earned income tax credit; fathers who support their children; a child support assurance program; and a low unemployment rate."

—**Bernard J. Stumbras, Visiting Fellow**
Institute for Research on Poverty,
University of Wisconsin-Madison

"In our judgment, attempts to nationalize and standardize the AFDC system should be resisted. A federal AFDC system would almost certainly lead to higher benefit levels in a large number of states (41 in one proposal). That, in turn, would lead to an increase, not decrease, in the incidence of poverty in the United States. Most disturbing, the rate of child poverty would increase. Thus public expenditures on public assistance would rise and poverty would increase as well, particularly for younger Americans for whom poverty has a particularly potentially debilitating long-term impact."

—**Professors Richard Vedder and**
Lowell Gallaway, Ohio University

"NACo policy calls for the gradual replacement of AFDC, AFDC/unemployed parent, general assistance, and food stamp programs with an income security program for persons unable to work. . . . In the interim, NACo supports a revised AFDC program that establishes uniform eligibility standards with regional adjustments for costs of living. Since poverty is a national problem, we have supported increased federal financial participation to a least 75% of all costs. We also support mandating national minimum benefit standards, *provided* that such a mandate is backed with federal dollars. . . . the experience local government has had over the past five years . . . leads us to believe that 'swap' concepts are unrealistic."

—**Councilmember Hilda Pemberton,**
Prince George's County, Maryland
Member, Employment Steering Committee,
National Association of Counties

case, federal funds—if they reduce their caseloads. Not surprisingly, there is great hesitation about doing either. A new approach—perhaps through a block grant or "performance bonuses" added to the matching grant—deserves careful study.

By the same token, perhaps the best step the federal government can take to reform welfare is to maintain a period of steadiness in national policy. The current round of innovations began with the defeat of the Carter Administration's "Program for Better Jobs and Income" in 1978. After a decade of uncertainty, the prospect of dramatic federal changes had come to an end, and state and local governments began to take matters into their own hands. Were the White House to put forth a sweeping consolidation of the existing programs, or a "swap" of responsibility for them, as proposed by ACIR, the momentum that has already built up behind welfare reform may well slow down until Washington decides what to do next.

It would be far better to recognize that a new era is underway. The national route to reforming welfare has

ended; the state and local one has begun. And while it may not always be smooth, it may offer a better chance to deal with the problems of poverty and dependency than we have had for a long time.

*Leslie Lenkowsky is President of the Institute for Educational Affairs, and adjunct professor of public policy at Georgetown University. His book **Politics, Economics and Welfare Reform** will be published in April.*

Deductibility: Elimination Can Bring More Equity and Stronger Federalism

Richard S. Williamson

President Reagan's tax reform proposal, including the provision to eliminate deductibility of state and local taxes, is good government and good federalism. Elimination of this tax deduction first must be viewed in its overall context: creating a simpler, more equitable tax system wherein the average American's tax burden is significantly reduced.

ACIR has calculated that 79% of all taxpayers, including many of those who currently deduct state and local tax payments, will get a tax cut, or pay the same amount in federal taxes, as a result of the President's proposed changes. Overall, according to ACIR, individual tax liability will be reduced by an average of 8.5%.

The current system of allowing for deductions of state and local tax payments has, according to ACIR, generally worked to the advantage of a small percentage of persons with high incomes living in states with high and steeply graduated tax rates. The two-thirds of Americans who do not itemize their deductions get no benefit at all from this provision, and end up subsidizing those who do. The average citizen in the 34 lower tax states ends up subsidizing high-income taxpayers in higher tax states. In other words, the current deduction causes a shift in federal income tax burdens, with higher income taxpayers in high-service, high-tax communities benefitting at the expense of average taxpayers in low-service, low-tax communities.

Opponents of the President's reform argue that it pits the 15 "high tax" states against the other 35. This charge suggests that such competition amongst states does not exist already. In fact, it does. There is competition amongst the states as Congress deals with

federal programs and distribution formulas for new programs and revisits targeting for existing ones. Here is competition amongst the states in dealing with departments and agencies as each seeks to get its fair share, and more, of limited federal dollars in grants, etc. The majority of states have offices in Washington, D.C. to wage just such competition in the halls of Congress and amongst the federal agencies.

I am not suggesting such competition is bad, but rather to put in perspective and appropriately discount the charge that this reform somehow is wrongheaded because it heightens competition amongst the states. Tax deductibility is but one of the many areas where competition already exists for the approximately \$150 billion in aid the federal government provides to state and local governments (grants-in-aid and tax deductibility).

Opponents of this reform also argue that the cruelest effect in "high tax" states would be on welfare programs and medicaid benefits for the poor. This charge is based on a false presumption that states and local governments, when faced with tough fiscal decisions, are somehow less compassionate than the federal government. In recent years, state and local governments have been faced with a significant federal retrenchment of grant-in-aid assistance and a recession that forced them to make extremely difficult budget decisions. The simple fact is that state and local governments faced these tough choices directly—even raising taxes as necessary—and with compassion. Both academic studies and press reports have clearly documented this phenomenon.

Then there is the cluster of charges critics make that the elimination of state and local tax deductibility will do damage to "federalism." They point out that if adopted, this reform proposal would abruptly end a pattern of federal-state relations that has governed policy-making for more than 70 years, since the begin-

ning of the modern income tax. They argue that we need to guard the vitality of state and local government, and this reform proposal would usurp still more traditional local tax sources for the federal treasury. And that, as costs rise, resistance to any kind of tax increase at the local and state level would be greater than now because the full weight would be felt by the individual taxpayer and not shared through deductibility with Washington.

It is important to guard the vitality of state and local governments. But, the overall pool of resources for state and local governments is much more dependent on a healthy economy than on deductibility.

A principal means to strengthen federalism is by sorting out responsibilities to provide for clearer accountability. That accountability, in turn, encourages greater citizen participation in government. If a citizen does not know who is responsible for what goes right or what goes wrong in government, he has less incentive to vote. After all, what difference does it make? Therefore, to move from cooperative federalism to sorting out responsibilities in our intergovernmental system has been recognized increasingly as a worthwhile federalism reform. The president's proposal to eliminate deductibility does just that.

Those who spend money at whatever level of government should bear the full political cost of raising the money they intend to spend. Citizens should be allowed to judge whether the full cost of their government at each level is justified by the services and benefits provided therefrom. Citizens then can exercise an informed judgment at the ballot box and take more control over their governments. This is not a chilling effect on state and local governments, but an invigorating one. For with clearer responsibility there can be more effective accountability and that is good in a democracy. More citizen participation invigorates local, state and federal governments.

Therefore, elimination of state and local tax deductibility can help not only create a simpler, more equitable tax system, but also further revitalize and strengthen our intergovernmental system.

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Deductibility and Federalism: The Ties That Bind

John J. Marchi

Years from now, when historians chronicle The Great American Tax Reform Effort of 1985-86, some may be moved to wonder, in awe, just how our Founding Fathers ever managed to write a Constitution without benefit of CPAs, economists and tax lawyers.

The Henry Steele Commagers and Arthur Schlesingers of the future could hardly be blamed for raising the question. For a long time throughout the summer, fall and winter of 1985, the Treasury Department, the White House, and the House Ways and Means Committee seemed intent on keying tax code overhaul strictly to a financial theme. How, the queries went, can we achieve a true tax reformation that will not only reach the golden mean of fairness-growth-simplicity, but also flourish in a climate of revenue neutrality?

What troubled many New Yorkers—among them Alfonso D'Amato, Daniel P. Moynihan, Warren M. Anderson, Mario Cuomo, as well as myself—was the quest for revenue neutrality as the be-all and end-all. The crucial issue, as some of us saw it—for New York and all of our sister states—was the proposal first surfaced by the Treasury Department to eliminate state and local tax deductions from the federal income tax return.

The strictly fiscal approach in my judgment, and that of the gentlemen above named, missed the point entirely. Considering a tax code rewrite from a strictly financial perspective ignored the fact that the issue is really an institutional matter.

What confronts the Nation is something vastly more important than a statistical analysis and reaction. The statistics and their import animate and provide some of the substance involved. But, in reality, we are dealing with the institutional issue of federalism. Simply put, elimination of deductibility would demolish the federal system of government as we know it. Abolishing it would be the fastest road to double taxation and, inevitably "Big Brother", central government.

But the deductibility battle is far from over. Certainly there was cause for some optimism when the House Ways and Means Committee voted to preserve state and local deductions, in the "simplified", 1400-page bill it turned loose just before Thanksgiving. And President Reagan's epic pre-holiday exertions on Capitol Hill produced crucial Republican votes needed to pass the House version and send it to the Senate, with deductibility intact. Mr. Reagan pinned his hopes on a Senate overhaul to preserve the marrow and fiber of the plan he embraced last summer, a version that would chuck deductibility into the dustbin of history.

Whether any change in the deductibility provision would emerge intact from a Senate-House conference on the bill remains doubtful. Some reports suggested that the Senate might turn to a unitary or value-added tax.

But the House Ways and Means bill was clearly a step in the right direction. What would be unacceptable ultimately would be a bill that eliminates or shaves state and local deductibility, as Ways and Means Chairman Dan Rostenkowski first suggested.

The worst nightmare one can conjure is the development of a package drawn strictly with numbers in mind. What constitutional damage can the accountants, economists and tax lawyers do when tinkering with the statutes? More than enough to set Madison, Hamilton and Jay spinning in their graves and darkening their Federalist Valhalla.

For, if Congress yields to the frenzy of the moment to produce a system of double taxation of state and local taxes, the result will ultimately include exhaustion of the states' revenues and a decrease in their ability to provide basic services for the people. Given that dark scenario, the federal government would inevitably assume responsibility for some of these programs which states and local units can no longer afford.

And, irony of ironies, the eventual effect would be exactly the opposite of the decentralized government President Reagan hopes to leave us as his legacy. With the power of states drained financially and spiritually, a central government would emerge, swollen with

power and money. Is that to be the payoff for Valley Forge and all of the many other agonies of those eight long years?

Was the disallowance of state and local tax deductibility, with an estimated yield of \$33 billion, going to actually solve our fiscal problems? Bear in mind that the interest on the United States debt alone amounted to over \$149.2 billion in fiscal 1986. No, it was merely the equivalent of less than eleven weeks of interest on the national debt, exclusive of payment of principal and all defense and non-defense spending.

When we consider that state and local governments provide virtually all of the basic public services and account for 14 million of 17 million public sector employees, a mortal blow to those services is scarcely worth 11 weeks of improvident federal interest payments on the national debt.

Is that what George Washington and the other Founding Fathers had in mind when they drove King George's Redcoats from our shores in 1783?

If tax reform is going to involve alteration of the most basic compact under which we have lived for two centuries, let's forget doing it by statute. Instead, let Congress honor the request made by our New York State Senate to originate a constitutional amendment shield to protect state and local revenue vulnerability. And let Congress then submit that amendment to the states for consideration.

The way would then be clean to expose the sinister nature of taxation without deductibility. And perhaps then, with all the implications made starkly visible, we can write deductibility into the Constitution on a permanent basis—without benefit of accountants, tax lawyers or economists.

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Canadian Experience With the Representative Tax System

Douglas H. Clark

The representative tax system (RTS) is used by the Government of Canada as a means of allocating federal grants to provinces on a basis of their relative need for financial assistance. The purpose of this article is to describe the role of the RTS within the Canadian system of intergovernmental grants.

Canada, like the United States, is a federal country in which some public goods and services are provided by the national government and some by regional (provincial) and local governments. Each level of government imposes taxes and, by and large, finances the services it provides by means of these taxes. However, services may also be financed by grants from other governments.

There are some remarkable similarities between the federal systems of Canada and the United States. Thus, the differing services provided by the central and regional governments are similar in the two countries, as are the ranges of taxes levied. At the local governmental level the similarities are particularly marked.

However, the two federal systems tend to diverge rather significantly in the case of intergovernmental grants. Thus, Canada places considerable emphasis on a type of grant not used by the United States Government, i.e., grants with no conditions imposed upon the receiving governments. Canada also emphasizes block grants with conditions of a very broad nature. The number of federal grant programs is much fewer in Canada than in the United States, but the total payments appear to be relatively twice as large.

The Canadian System of Intergovernmental Grants

Like the United States, Canada has a well-established system of intergovernmental grants. There are large grants from the federal government to the provinces and from the provinces to local governments. Relatively small grants are paid from the federal government to local governments, but there can be little doubt that local governments—who are “creatures of the provinces”—benefit greatly from the system of federal-provincial grants.

There are various rationales for federal grants. Two are of particular importance. First, federal grants are paid because of a perceived “national” interest in certain services which are provided by provinces. Second, grants are paid to some provincial governments because of a perception that they are less able than others to provide the public services for which they are responsible.

In the 1985-86 fiscal year (ending March 31, 1986), federal cash grants to provincial and local governments will total an estimated \$21 billion, or approximately 20% of total federal budgetary expenditures.¹ Approximately \$13 billion of these grants is being paid for health, post-secondary education, and welfare programs administered by the provinces (including insured medical and hospital services), \$5 billion for equalization payments to needy provinces, and \$3 billion for a small number of other programs. (In order to put Canadian numbers such as these in terms of an American equivalent it is customary to multiply them by ten, given that the U.S. economy is approximately ten times as large as the Canadian.)

The allocation of federal grants among provinces is, of course, a matter of great importance. Some Canadian grants are allocated on an equal per capita basis. Some are distributed on a cost-sharing basis for certain defined expenditures. Equalization payments are allocated on a basis of need, that is defined in terms of disparities in the relative revenue-raising capacities of provinces. Various other methods of grant allocation also are used.

Six provinces, with approximately 40% of total provincial population, presently qualify for equalization. Four relatively well-off provinces, which have approximately 60% of total population, do not qualify. The distributional impact of the \$5 billion in equalization payments on provincial revenues is therefore very large.

The importance of the equalization program to provinces is illustrated by *Chart 1* that indicates the estimated proportions of total provincial revenues in 1985-86 accounted for by federal grants for health and education; welfare; and equalization.²

The remainder of this article will describe Canada's equalization program, and will deal with the central role of the RTS in this program and its further use in evaluating the fiscal health of the provincial-local government sector.

CANADA'S EQUALIZATION PROGRAM

The purpose of Canada's equalization program is set out in section 36.(2) of the Constitution as follows:

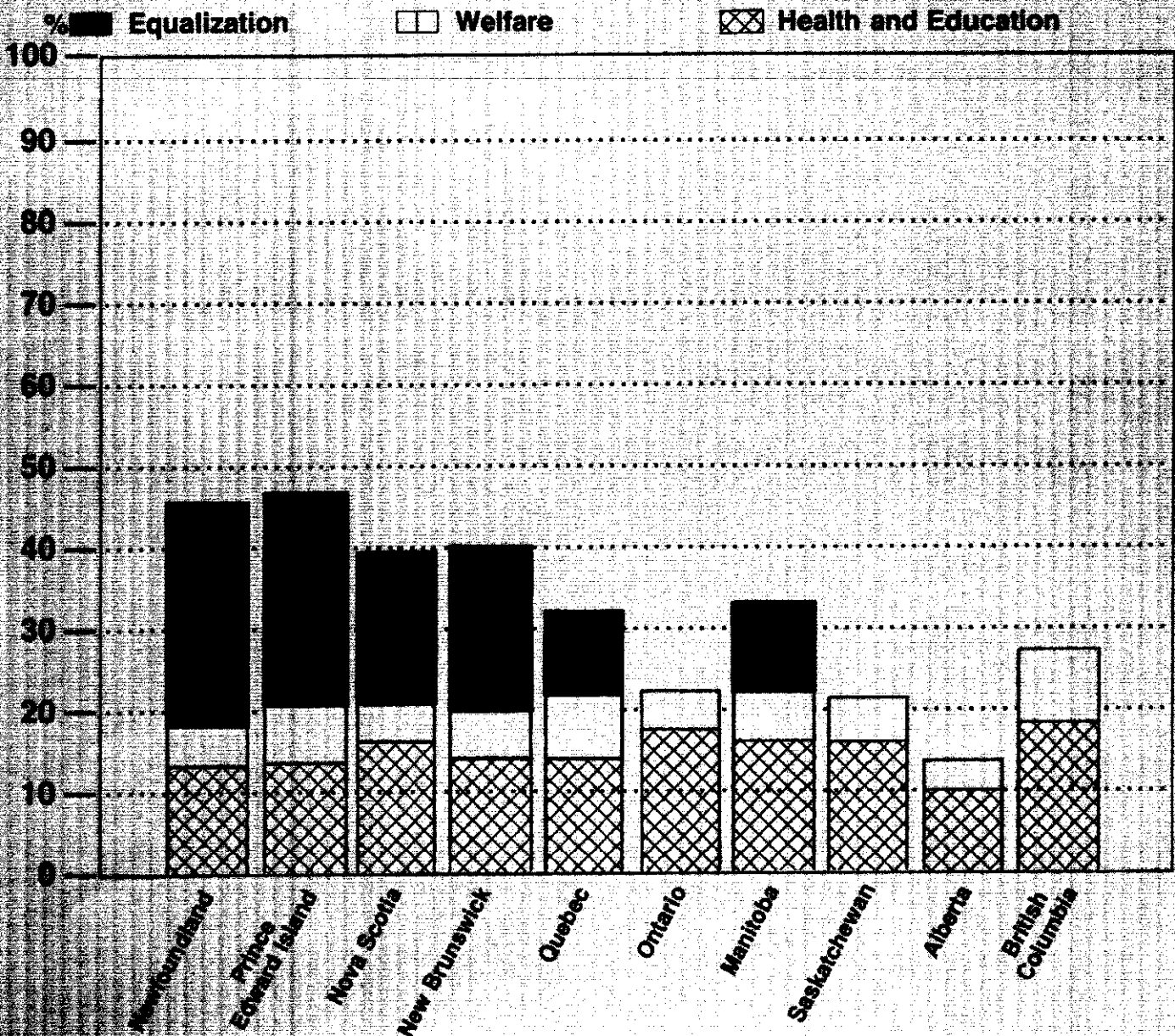
"Parliament and the Government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

This provision was added to the Constitution in 1982. However, similar statements about the intent of the program go back to its origin in 1957, and indeed even earlier, to 1940, when the concept of equalization was first proposed by a Royal Commission.

Although equalization has a distinct purpose, program payments have always been made free of any conditions. Neither the federal government nor the provinces have considered that it would be appropriate for the federal government to specify levels of taxation or public services that provinces should provide. Any province receiving equalization is therefore free to use funds from this source to raise its levels of public services or to lower its levels of taxation, or some combination of the two.

The equalization program covers local as well as

CHART I
MAJOR FEDERAL GRANTS TO PROVINCES AS A PERCENT OF GROSS PROVINCIAL REVENUES, 1985-86



provincial governments. This is done by collectively taking each province's municipalities and school authorities, etc., into account in determining its eligibility for equalization and the amount of any payment it receives. Although equalization payments are not made directly to local governments, it is inevitable that payments to an equalization-receiving province will, in one way or another, benefit its local governments.

The need for an equalization program in Canada arose for two reasons: first, because Canada is a federal state; and second, because Canada has had a persistent problem of regional economic disparities. As a consequence of these regional disparities, any given level of taxation will tend to raise more money in high-income provinces than in low-income provinces. In the absence of some countervailing action of the kind provided by an equalization program, the low-income provinces would normally have higher levels of taxation and/or lower levels of public services than the high income provinces, in some cases markedly so. Successive Canadian Parliaments have felt that such a situation would weaken Canadian unity, and political spokesmen have frequently referred to the equalization program as "the cornerstone of Canadian federalism".

The equalization program is not intended to address the underlying problem of regional economic disparities. Accordingly, payments are made to *governments* and are based upon the measured well-being of these governments as distinct from their residents. (In fact, it is possible, although not likely, for a particular region to have *residents* whose average incomes are relatively low but a *government* whose total per capita revenues from taxation—perhaps because of large natural resource rents—tend to be relatively high. In such circumstances, no equalization payment would be warranted.) While payments are made to governments, their ultimate impact is upon individuals since the well-being of individuals is influenced not only by

their cash incomes, but also by the goods and services they receive from their provincial and local governments and the provincial and local taxes they pay.

Calculation of Equalization Entitlements

Equalization is a "formula-based" program. Entitlements are calculated by a formula with three basic steps:

- Estimate the total amount of revenue per capita that each province could raise by imposing a *standard tax system*.
- Determine the level of revenue per capita to which each province is entitled to be raised. This is done by estimating the total amount of revenue per capita that a prescribed set of middle-rich provinces, known as "standard provinces", would obtain from the same standard tax system.
- Compare the per capita amounts from steps (1) and (2) for each province. If the amount under step (1) for any province is less than the amount under step (2), that province has a per capita equalization entitlement equal to the amount of its shortfall.

These steps are illustrated by *Chart II* and *Table 1*. *Chart II* indicates two important things about equalization. First, it illustrates how the equalization program got its name because it shows that, after taking account of equalization, the total per capita fiscal capacities of each of the eligible provinces are equal.

Second, *Chart II* demonstrates that the equalization formula has two basic elements:

FISCAL CAPACITY = the estimated per capita revenues that a province can obtain from imposing a standard tax system; and

TABLE 1: CALCULATION OF EQUALIZATION ENTITLEMENTS, 1985-86

Province	(1) Average Per Capita Yield of RTS in Standard Provinces (\$)	(2) Per Capita Yield of RTS in Province (\$)	(3) Per Capita Shortfall of Province from Standard Provinces (Col. 1 - Col. 2) (\$)	(4) Population (000)	(5) Equalization Entitlement (Col. 3 x Col. 4) (\$000,000)
Newfoundland		1,895	1,036	581	602
P.E.I.		1,928	1,003	127	128
Nova Scotia		2,284	647	881	570
New Brunswick		2,129	802	719	577
Quebec		2,516	415	6,581	2,734
Ontario		3,110	—	9,064	—
Manitoba		2,579	352	1,070	377
Saskatchewan		3,321	—	1,019	—
Alberta		6,333	—	2,348	—
British Columbia		3,310	—	2,891	—
Total	2,931			25,281	4,988

EQUALIZATION STANDARD = the estimated average per capita revenues that the standard provinces can obtain from the same tax system—a level to which all provinces are entitled to be raised by the equalization program, and one that is considered sufficient to make it possible for all provinces to provide their residents with reasonably comparable public services if they levy reasonably comparable taxes.

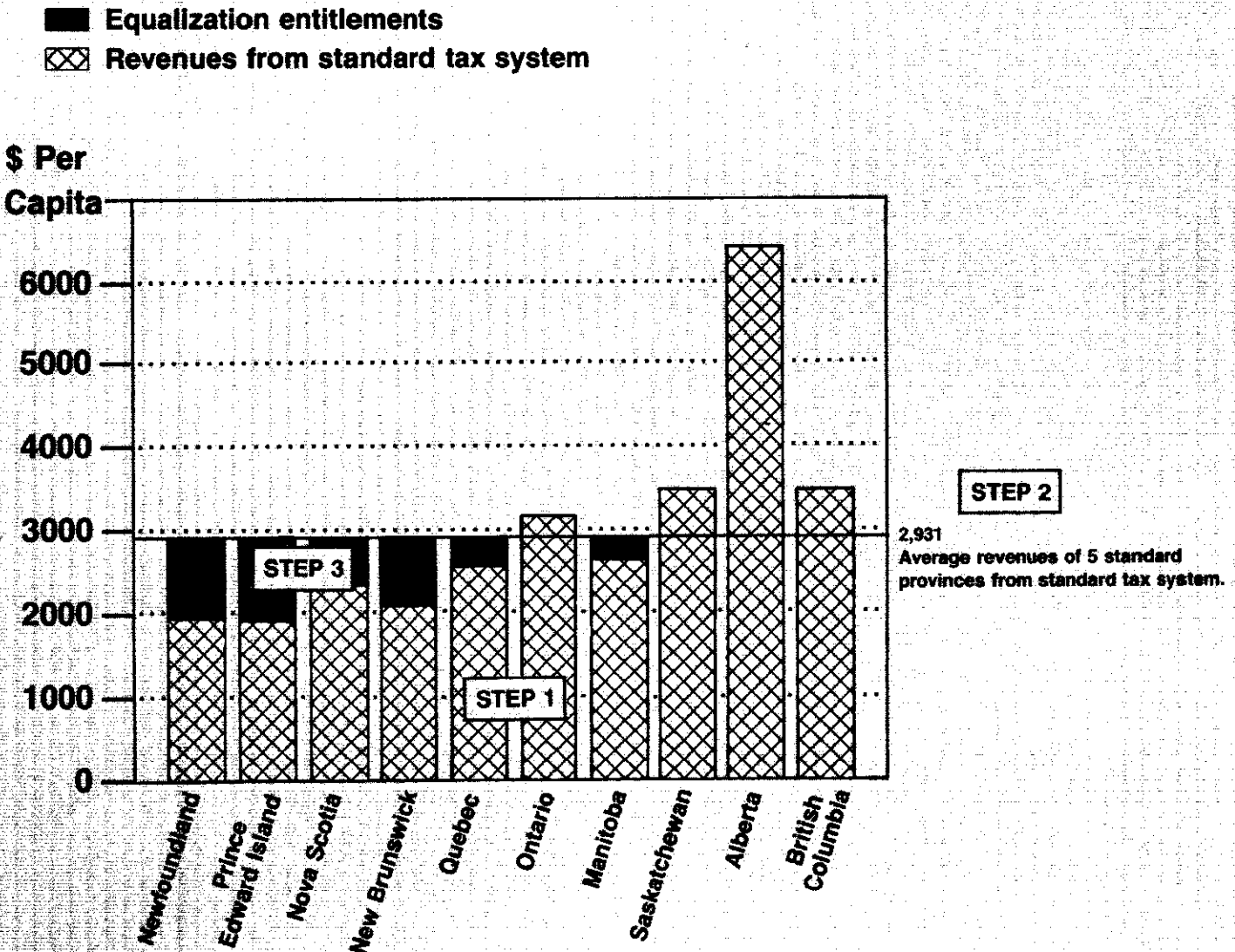
tem. This leads to consideration of the RTS because the standard tax system that is used to determine Canadian equalization entitlements is the RTS.

Both fiscal capacity and the equalization standard are determined with reference to a standard tax sys-

THE CANADIAN REPRESENTATIVE TAX SYSTEM

The Canadian equalization program was introduced in 1957, at one of the quinquennial renewals of what are known as the “federal-political fiscal arrangements”. Prior to that time, these arrangements had related mainly to a cooperative system for sharing revenues from the personal income tax, the corporation income tax, and the estate tax. The original equalization formula was limited to these three taxes, but was in effect a “mini-RTS” that incorporated highly reliable data on tax yields derived from the revenue sharing system. The equalization program was widely accepted, and in 1967 was enlarged to take account of

**CHART II
HOW EQUALIZATION ENTITLEMENTS
ARE CALCULATED, 1985-86**



all provincial taxes on income, consumption, property and natural resource rents, as well as various licenses, fees and service charges.

While local government revenues were excluded from the enlarged equalization program in 1967, it is fair to say that a comprehensive RTS was put in place at that time. In taking the decision to adopt the RTS, Canada was profoundly influenced by pioneering work on the concept by the Advisory Commission on Intergovernmental Relations, set out in a 1962 publication entitled *Measures of State and Local Fiscal Capacity and Tax Effort*.

The original Canadian RTS may be referred to as "RTS 1967" and it was succeeded, at five-year intervals, by RTS 1972, RTS 1977 and RTS 1982. The latter is presently in effect and will apply until its expiry in 1987. Each of these representative tax systems has been based upon the concept of devising a tax system that would be typical, in both rates and structures, of all of the taxes, licenses and fees, etc., currently levied by provincial, or provincial and local, governments. School purpose taxes were added to the system in 1973. Municipal taxes, together with local government revenues from sales of goods and services, were added in 1982. The Canadian system goes somewhat beyond pure taxation revenues, and can appropriately be referred to as a "representative revenue system". However, this term is not used in Canada.

How the RTS is Used to Estimate Fiscal Capacity

The fiscal capacities of each province have therefore been estimated by means of successively defined representative tax systems since 1967. This has been done by estimating the total amount of revenue that each province could raise each fiscal year from the RTS then in effect. Such estimates are made separately for each tax and non-tax source of revenue. (For convenience, we refer to each kind of revenue as a "tax" whether it is a genuine tax, a quasi-tax, or a non-tax.)

More specifically, the procedure to estimate fiscal capacity is as follows. For each tax in the system, the *average provincial tax rate* for the fiscal year is applied to the estimated value of each province's standardized *tax base* for that source. The average provincial tax rate is determined by dividing the total revenues of the ten provinces from a tax by the total tax base of the ten provinces for that tax, as measured for purposes of the RTS. The tax base is determined with reference to a definition that is intended to be typical of the various bases actually used by provinces for that tax. The resulting revenue yields from applying tax rates to tax bases are then summed for each province to give its total estimated yield for the RTS—that is, its "fiscal capacity".

Revenue Classification in the Canadian RTS

The initial step in applying an RTS, and one that is sometimes overlooked, is the classification of provincial-local revenues into categories or sources. Ideally, a separate revenue source should be established for every kind of tax which has a distinctive distribution of tax base among the ten provinces.

The present RTS has 39 categories and comes reasonably close to meeting this ideal. The RTS estab-

lished in 1967 had only 16 revenue sources. This has increased gradually over the years to the present number. Some revenue categories have been added as a result of enlargement of the equalization program by the federal government. Others have been added to take account of new revenue sources developed by provinces, such as lotteries and payroll taxes. However, most of the new categories have stemmed from efforts to improve the quality of inter-provincial comparisons. For example, in 1977 revenues from alcoholic beverages were split into separate sources for spirits, wine and beer in order to reflect the varying degrees to which provinces can derive revenues from these products owing to differences in the elasticity of demand and also their regionally-distinctive patterns of consumption. Similarly, in 1982 a special category was established for heavy oil because its economic rent tends to be less than that from conventional oil, and there are distinctive patterns of regional production, with heavy oil being concentrated in Saskatchewan and conventional oil in Alberta. Quite a number of natural resource revenue categories have been added for similar reasons.

Natural resources account for almost half of the total number of categories in the present RTS. This is partly a reflection of the importance of natural resources as a source of inter-provincial disparities in Canada and partly a reflection of the well-known tendency of natural resources of any kind to have a unique geographical incidence. One reason for the importance of natural resources as a source of provincial revenues is that most sub-surface rights to minerals in Western Canada are owned by provincial governments.

The Definition of Tax Bases in the Canadian RTS

The most important element in measuring fiscal capacity is the definition of tax bases, since it is the tax base amounts which determine how rich or poor a province is, whether it qualifies for equalization, and if so, by how much. A definition must be made for each revenue category. This has proven to be a difficult, technical task, in part because each tax base must reflect the increasingly complicated tax structures of the ten provinces. Fortunately, problems with the important income taxes have been minimized because the ten provinces continue to levy personal and corporation income taxes on a remarkably uniform basis that is closely tied to the federal system. Other taxes frequently present more difficulties. The various tax base definitions have been worked on over a period of some 20 years, and many of the most difficult problems have been resolved in a satisfactory manner. Of course, problems remain. At the present time, work is being done on a number of tax bases, including those for property taxes, general sales taxes, and lotteries. This work is done in close consultation with the provinces. Inevitably, however, there is a continuing need for some changes to tax bases because each annual round of provincial budgets tends to bring changes in the typical structure of some provincial taxes. For this reason alone, the RTS will always need periodic updating.

Table 2 provides a brief summary of the 39 revenue categories in the present RTS and the accompanying tax base definitions.

TABLE 2: SUMMARY OF THE 1982 RTS

Type of Revenue	Number of Revenue Sources	Summary of Tax Base Definition
Personal income tax	1	Total simulated yield in province of the average provincial personal income tax rate applicable to each tax bracket as these brackets are defined for purposes of federal tax. (This is done by a federal personal income tax model.)
Corporation income tax	1	Portion of taxable income of corporations allocated to province by a <i>standard allocation formula</i> set out in the Income Tax Regulations and accepted by all provinces.
Consumption taxes (general sales taxes, taxes on gasoline, alcohol, tobacco, etc)	9	Value or volume of consumption in the province of taxable good or service.
Property taxes	1	Value of buildings included in capital stock in province for <i>building component</i> of property taxes; gross provincial product, with some adjustments, used for <i>land component</i> of property taxes.
Taxes on natural resource rents	18	Value or volume of production in the province of natural resource in most cases; actual revenues of province from resource used in two cases.
Estate taxes	1	Total income of high income taxpayers in province, with increased weight for taxpayers aged 65 and over.
Taxes on corporation capital	1	Value of those elements of corporation capital that are typically taxed, such as equity capital, reserves and long-term debt—with higher weight for amounts attributable to financial institutions.
Health insurance premiums	1	Estimated number of persons liable for typical premium in province.
Payroll taxes	1	Value of wages and salaries paid in province.
Lotteries	1	Personal disposable income in province, with some adjustments.
Motor vehicle licenses, non-commercial	1	Number of passenger vehicle registrations in province.
Motor vehicle licenses, commercial	1	Value of capital stock of vehicles sold in province over five year span.
Miscellaneous taxes and non-tax revenues	2	Weighted average of province's tax bases for all non-resource revenue sources; actual revenues of province for one minor source.

Some of the tax bases listed in *Table 2* are not the statutory bases that are actually used by provinces or local governments, but rather proxies for the actual bases. If a proxy base has a distribution among provinces that is similar to the distribution of the typical actual base, it should produce a result that will be similar to the result that would be obtained if the actual base could be used. This is important because statistical data are sometimes not available for actual tax bases on a uniform basis for all provinces.

Estate taxes provide an example of a proxy base. The actual tax base for estate taxes (actually known as "succession duties" when levied by provinces) has been the value of the estate or of the bequest. Provinces have been withdrawing from this field, and there are no longer suitable data on estates or bequests that could be used for purposes of intergovernmental comparison. However, there are good data on the total income of persons in high tax brackets, with separate data for persons aged 65 and over, from which a suitable proxy base can be developed. Where it is necessary to employ a proxy base, every effort is made to use one that is supported by statistics of good quality for purposes of inter-provincial comparisons.

Population

One final element of the RTS is population. Population is used to compare provinces of different size, and is a measure of provincial expenditure need—it being assumed that, on an overall basis, such needs are equal per capita for all provinces. As a consequence, population is undoubtedly the important single input into the equalization formula. Fortunately, Canadian population data appear to be of good quality. Annual data are related to census benchmarks, and a census is taken every five years. In addition, considerable attention has been given in census planning to means of reducing the extent of a phenomenon known as "census under-enumeration"; i.e., the number of people who, for any reason, are not counted in a census.

Alternative to the RTS

The RTS is not the only means of estimating provincial fiscal capacities. From the very beginning, consideration has been given in Canada to the use of an alternative which would be based upon some broad "macro concept" of provincial income or provincial product. In the 1950s, attention focused on the concept of *personal income*, for which data were readily available. In the 1960s and early 1970s, attention focused on a *weighted combination of personal income and corporation taxable income* which took account of the relative proportions of provincial taxes paid by individuals and business enterprises. More recently, interest has shifted to *gross domestic provincial product*, which has been published each year by Statistics Canada beginning with 1977. Although the latter series is published on an "experimental basis", most of its components are considered to be of good quality and it has been used in both RTS 1977 and RTS 1982 as a proxy for certain tax bases which relate very broadly to economic activity.

The Canadian rationale for choosing a representative tax system essentially has been that this reflects the real world of what provinces collectively choose to

tax. Accordingly, it gives the most weight to those things which provinces tax most heavily, such as:

- consumer goods for which there is an inelastic demand—such as gasoline, beer, tobacco and lottery tickets (but not food because provinces choose not to tax it);
- real property—because it is immovable, making tax evasion almost impossible;
- economic rents—especially from natural resources (which can be taxed without affecting output decisions or giving rise to a misallocation of the factors of production);
- non-residents—for example, the application of retail sales taxes to goods and services that tourists are known to buy heavily.

The latter two categories both relate to a phenomenon known as the "exportation of taxes"—a matter that the RTS automatically takes into account.

Macro-concepts of fiscal capacity do not, and are not intended to, recognize distinctions collectively made by provinces in their actual systems of taxation. As a result, these concepts fail to reflect adequately the uneven provincial distribution of many things that are taxed heavily and they do not provide a sensitive measure of fiscal capacity.

The advantage of the RTS can be stated in another way. The RTS provides a direct measure of the fiscal capacity of *governments*, whereas macro-measures of capacity relate to the capacity of the total economies over which governments have jurisdiction. Since grants such as equalization are paid to governments, there is a *prima facie* case for basing them upon a fiscal capacity measure such as the RTS that relates to governments. However, there is a continuing recognition in Canada that macro-concepts of fiscal capacity have advantages. For example, they are considered to be more "neutral" because they are less likely to influence the behavior of provincial governments or to be biased by certain actions that provinces may take. Macro-concepts are therefore likely to continue to be considered at each quinquennial renewal of the equalization program.

If gross domestic provincial product or some other macro-economic measure were to be used to measure fiscal capacity, the concept of a "standard tax system" as illustrated in *Chart II* could be retained, but in this event, the same measure of tax base would be used for each tax in respect of which equalization is calculated. There would then be no need to classify provincial-local revenues into sources.

Other Uses of the RTS

The RTS provides data inputs which make important fiscal comparisons among provinces possible. Accordingly, indices of fiscal capacity and of tax effort, of the kind that the Advisory Commission on Intergovernmental Relations now calculates in the United States, are produced following every official calculation of equalization. In addition, indices of fiscal capacity are produced, *post-equalization*, which indicate the striking effect that this program has on reducing disparities among provinces. The various indices help

governments monitor the state of horizontal fiscal balance in the Canadian federation and are useful for general policy purposes.

Apart from equalization, indices of fiscal capacity have also been used in some relatively small federal-provincial programs where it is intended to provide benefits to provinces that have revenue-raising capacities below certain specified levels.

CONCLUSIONS

Canada has successfully operated an RTS since 1967. The RTS is built into Canada's large equalization program which provides annual financial support, with no strings attached, to financially-disadvantaged provinces on a formula basis. The purpose of these grants is to make it possible for all provinces to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. The RTS is used to allocate equalization payments because it is considered to provide the most sensitive and realistic means of comparing provinces in respect of their revenue-raising capacities. The present RTS takes account of all provincial and local taxes and almost all other provincial-local revenues from own sources.

Footnotes

¹In addition, the federal government transfers a further amount to provinces of approximately \$7 billion (for health, education and welfare) in a form known as a "tax transfer". A tax transfer is a transfer of "tax room" by one level of government to another, which is achieved by one level of government reducing its rates for one or more kinds of tax in order that another level of government can make a corresponding increase in its own rates for the same taxes, without there being any change in the overall burden on the taxpayer.

²Chart I includes tax transfers for health, education and welfare, as well as cash transfers for these programs and for equalization.

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Tax Reform and Federal Individual Income Tax Liabilities

Carolyn D. Lynch
Analyst

As part of a larger study on the fiscal effects of comprehensive tax reform of the the federal income tax structure on state and local governments, the Advisory Commission on Intergovernmental Relations (ACIR) is analyzing the impact of various tax reform proposals on federal income tax liabilities. The research was supported in part by a grant from the Ford Foundation.

The purpose of this analysis is to determine how the various tax reform plans would affect the federal income tax liability of citizens in different states and income classes. Preliminary information is now available on how the President's and the House-approved plans would affect federal personal income taxes on a state-by-state basis.

The ACIR has contracted with deSeve Economics Associates to provide the data necessary to analyze the effects of federal tax reform. The data supplied by deSeve Economics are based on microsimulation modelling of the federal income tax system. The data base used in the computer simulation by deSeve Economics is conceptually the same data file that the U.S. Department of the Treasury and the Joint Tax Committee use as their primary data source for analysis and revenue estimates of all federal individual income tax changes.¹ The number of records in the deSeve data base, however, is substantially larger and, therefore, permits the calculation of meaningful results on a state-by-state basis. The statistical procedures employed in the development of the deSeve data base used projections of the national economy based on

the Administration's (February 1985) economic forecasts.

Both tax reform plans contain some provisions that would increase federal tax liability over current law and others that would decrease liability. It is the net effect of these two types of changes, when they are combined in a comprehensive reform plan, that determines whether a particular tax reform proposal increases or decreases tax liability, or leaves it unchanged. It is important to note that certain provisions of both the President's and the House-approved plans cannot be captured by microsimulation techniques. For both plans, it was possible to estimate the effects of approximately 98% of the revenue-losing provisions and 73% the revenue-gaining provisions. This means that the estimated changes in tax liability derived from the microsimulations are overstated by approximately 25% in both cases. The simulated national reduction in personal income tax liability is 9.2% under the President's proposal and 9.6% under the House-approved plan. When the figures are adjusted for the 25% overstatement, total federal personal income tax liability is estimated to fall by 6.9% under the President's plan and 7.2% under the House-approved plan.

The Differential Impact of the Two Plans

A state-by-state comparison of the impact of the President's and the House-approved tax reform proposals on federal individual income tax liabilities is presented in the table on pages 32-33. The effect of the two reform plans on federal

personal income taxes paid by all residents of a state, and a breakdown for five income classes within each state, are given. The preliminary estimates are based on 1986 levels of income and are designed to present the permanent or fully phased-in effects of all provisions of the tax reform plans, even though some provisions would not actually take full effect until years subsequent to 1986. Federal individual income tax liabilities were estimated for five income classes within each state under current federal tax law and for each of the two reform plans. From these estimates, the percent changes in federal income tax liabilities from current law for each income class and reform plan were calculated. The figures in the column headed "weighted average of all classes" are based on estimates of aggregate federal income tax liabilities under current law and the two reform plans for all residents of a particular state. The figures, therefore, indicate the average change in liabilities for all taxpayers of that state.

Total federal individual income tax liabilities for the entire nation are estimated to decline by approximately 9% under both the President's and House-approved tax reform proposals.² The reduction in federal individual income taxes, however, would vary considerably by income class and by state under the two plans. Under the Administration's proposal, the decline in aggregate federal income tax liabilities would range between -15.0% for Alaska to -2.9% for Minnesota, a difference of 12.1 percentage points.³ The House-approved plan demonstrates

a range of about one-half that of the Administration's plan. The variation across states under the House bill would range between -13.2% for Tennessee to -6.2% for Idaho, a difference of 7.0 percentage points.

The Role of the Deduction for State and Local Taxes

While further analysis must be done to determine how the various provisions under each plan affect the changes in federal personal income taxes, the treatment of the deduction for state and local taxes is likely to explain a fairly substantial portion of the differential impact of the two plans across states.⁴ Taxpayers residing in a state with high state and local taxes, such as New York, would, on average, experience a 4.9% decline in federal income tax liabilities under the President's plan, and an 8.8% decline in individual income taxes under the House bill. In contrast, the average decline in federal individual income tax liabilities in Connecticut, a state with a below average state and local tax burden, would be 11.3% under the Administration's plan and 10.4% under the House plan.

The interstate differences for a given plan become even more

Interstate Tax Difference for Income Taxpayers in the \$50,000-\$99,999 Income Class: Percent Change in Federal Liabilities from Current Law

	The President's Plan	The House Plan
New York	+1.8%	-5.4%
Connecticut	-10.8%	-8.0%

dramatic for high-income earners, due largely to the differing treatment accorded the payment of state and local taxes, in general, and state and local income taxes, in particular. The fact is underscored by the data set forth comparing New York, which relies heavily on a personal income tax, and Connecticut, a state that does not have a broad-based income tax (see box).

It should be noted that the data presented here are based on total federal individual income taxes paid by all residents of a particular state or income class within the state. The percent changes, therefore, indicate the average change in liabilities for all taxpayers in a given state or income class within that state. The tax liability of any one taxpayer residing in a particular state or income class, however, will depend on many factors that are unique to that individual

and, therefore, may vary substantially from the average change in taxes paid by all individuals in a given income class or state.

Footnotes

¹The deSeve data base was constructed by merging tax return data from the Statistics of Income file generated annually by the Internal Revenue Service with demographic data from the Current Population Survey. In addition, pertinent information from several other sources on such items as fringe benefits and employer paid benefits has been statistically imputed to each record.

²This estimate and those stated below are somewhat overstated. See the explanation given above and on the table on pages 32-33.

³These figures are presented in the columns headed "weighted average of all classes."

⁴The President's proposal repeals the provision allowing the deduction for state and local taxes. In contrast, the House-approved plans sets a floor under all itemized deductions of \$500 per personal exemption, i.e., all deductions above an amount equal to \$500 times the number of personal exemptions would be allowed. State and local taxes are a major itemized deduction.

**PRELIMINARY ESTIMATES OF CHANGES IN
1986 TOTAL FEDERAL PERSONAL INCOME TAX LIABILITIES
UNDER THE PRESIDENT'S AND HOUSE-APPROVED TAX REFORM PROPOSALS
BY INCOME CLASS***

	PERCENT CHANGE FROM CURRENT LAW: THE PRESIDENT'S PLAN ^a						PERCENT CHANGE FROM CURRENT LAW: THE HOUSE PLAN ^b					
	INCOME CLASS						INCOME CLASS					
	Weighted Average of All Classes ^b	10,000— 19,999—	20,000— 29,999—	30,000— 49,999—	50,000— 99,999—	100,000	Weighted Average of All Classes ^b	10,000— 19,999—	20,000— 29,999—	30,000— 49,999—	50,000— 99,999—	100,000
New England												
Connecticut	-11.3%	-8.8%	-9.3%	-10.6%	-10.8%	-12.4%	-10.4%	-12.1%	-8.0%	-11.5%	-8.0%	-10.2%
Maine	-8.4%	-11.9%	-8.3%	-7.0%	-7.7%	-7.4%	-11.8%	-20.8%	-13.3%	-9.9%	-9.6%	-7.9%
Massachusetts	-9.4%	-7.3%	-9.6%	-7.8%	-6.3%	-12.3%	-9.8%	-12.5%	-10.1%	-9.3%	-7.6%	-9.5%
New Hampshire	-11.0%	-9.8%	-10.0%	-9.9%	-11.5%	-12.2%	-10.9%	-15.4%	-10.0%	-11.9%	-9.3%	-7.6%
Rhode Island	-8.6%	-11.0%	-9.4%	-10.2%	-3.4%	-8.0%	-10.6%	-18.9%	-9.7%	-11.9%	-5.1%	-7.4%
Vermont	-9.8%	-10.9%	-8.2%	-10.4%	-7.4%	-10.0%	-10.6%	-16.1%	-9.8%	-12.7%	-7.0%	-8.1%
Mideast												
Delaware	-5.9%	-9.7%	-3.4%	-3.5%	-5.8%	-6.8%	-8.9%	-15.5%	-5.8%	-6.4%	-8.6%	-9.3%
Washington, DC	-7.8%	-13.1%	-10.2%	-6.2%	-1.7%	-9.2%	-8.7%	-19.7%	-10.6%	-8.3%	-4.9%	-6.7%
Maryland	-7.3%	-10.7%	-7.4%	-3.4%	-6.6%	-10.2%	-9.0%	-18.4%	-8.8%	-7.6%	-7.3%	-8.6%
New Jersey	-10.1%	-14.2%	-9.2%	-8.0%	-7.4%	-12.0%	-10.6%	-21.9%	-10.0%	-10.0%	-7.9%	-9.6%
New York	-4.9%	-12.1%	-7.9%	-2.6%	1.8%	-6.8%	-8.8%	-18.4%	-8.8%	-7.4%	-5.4%	-8.6%
Pennsylvania	-9.9%	-10.4%	-9.0%	-9.2%	-8.2%	-12.0%	-10.4%	-16.1%	-9.5%	-10.6%	-8.1%	-9.0%
Great Lakes												
Illinois	-10.7%	-10.8%	-8.1%	-8.9%	-9.7%	-13.6%	-10.3%	-15.8%	-8.5%	-9.5%	-8.7%	-10.0%
Indiana	-11.6%	-11.5%	-6.9%	-10.5%	-11.8%	-14.3%	-11.2%	-18.8%	-9.0%	-10.9%	-9.6%	-9.8%
Michigan	-7.2%	-10.8%	-7.2%	-5.8%	-4.6%	-10.6%	-9.9%	-19.4%	-9.0%	-9.6%	-7.5%	-9.0%
Ohio	-10.5%	-10.0%	-10.9%	-9.9%	-9.0%	-11.8%	-10.5%	-15.1%	-11.9%	-11.0%	-8.3%	-8.0%
Wisconsin	-5.0%	-9.3%	-8.3%	-5.4%	-1.9%	-1.1%	-9.2%	-14.5%	-9.5%	-9.5%	-5.9%	-8.7%
Plains												
Iowa	-7.6%	-9.4%	-4.9%	-6.0%	-4.9%	-12.1%	-8.9%	-11.7%	-6.5%	-8.0%	-7.6%	-9.9%
Kansas	-8.5%	-7.8%	-6.1%	-8.0%	-7.0%	-10.5%	-8.4%	-13.9%	-6.8%	-9.9%	-6.5%	-6.9%
Minnesota	-2.9%	-7.4%	-5.5%	-2.2%	2.1%	-4.3%	-6.9%	-9.5%	-6.4%	-6.3%	-5.2%	-6.3%
Missouri	-10.0%	-10.2%	-6.1%	-9.1%	-10.0%	-11.6%	-9.9%	-16.5%	-5.7%	-10.6%	-8.6%	-7.8%
Nebraska	-9.1%	-5.2%	-5.0%	-8.7%	-10.0%	-11.4%	-8.3%	-9.2%	-5.3%	-9.3%	-8.1%	-6.7%
North Dakota ^c	-	-	-	-	-	-	-	-	-	-	-	-
South Dakota ^c	-	-	-	-	-	-	-	-	-	-	-	-
Southeast												
Alabama	-10.5%	-11.5%	-6.9%	-10.2%	-7.7%	-13.3%	-10.8%	-21.4%	-8.4%	-10.1%	-5.4%	-9.0%
Arkansas	-11.5%	-14.6%	-9.9%	-11.0%	-8.8%	-11.7%	-11.4%	-23.9%	-11.0%	-10.8%	-6.8%	-6.9%
Florida	-12.8%	-12.7%	-9.4%	-11.5%	-12.0%	-14.5%	-9.8%	-18.5%	-9.2%	-10.2%	-6.8%	-8.0%
Georgia	-9.0%	-14.2%	-8.8%	-6.9%	-5.1%	-11.1%	-11.4%	-23.6%	-11.7%	-8.6%	-7.0%	-9.1%
Kentucky	-9.3%	-11.0%	-6.2%	-6.4%	-8.5%	-14.3%	-10.5%	-20.5%	-7.7%	-8.2%	-7.7%	-10.7%
Louisiana	-14.7%	-17.7%	-10.7%	-12.5%	-14.2%	-16.5%	-12.2%	-24.9%	-11.0%	-10.6%	-10.9%	-10.2%
Mississippi	-12.2%	-20.8%	-9.6%	-10.3%	-10.4%	-11.4%	-12.2%	-32.8%	-11.7%	-9.7%	-8.5%	-5.3%
North Carolina	-8.2%	-12.4%	-6.2%	-8.1%	-4.2%	-8.7%	-10.3%	-21.5%	-10.6%	-10.3%	-5.7%	-5.3%
South Carolina	-9.9%	-13.6%	-6.9%	-7.2%	-7.2%	-12.5%	-11.6%	-22.6%	-8.9%	-8.6%	-8.3%	-9.6%
Tennessee	-13.7%	-17.8%	-10.3%	-12.0%	-13.6%	-14.0%	-13.2%	-30.7%	-11.3%	-11.9%	-9.1%	-9.5%
Virginia	-8.2%	-12.5%	-7.1%	-6.4%	-6.3%	-10.1%	-9.3%	-19.5%	-8.6%	-8.0%	-8.2%	-7.2%
West Virginia	-12.3%	-12.1%	-11.9%	-12.9%	-10.3%	-12.0%	-12.7%	-17.9%	-12.5%	-13.9%	-9.7%	-8.8%

Southwest						
Arizona	-8.0%	-11.6%	-5.7%	-6.8%	-5.4%	-10.2%
New Mexico	-10.8%	-10.7%	-9.9%	-8.7%	-10.3%	-12.7%
Oklahoma	-9.3%	-8.8%	-6.4%	-7.1%	-8.2%	-11.4%
Texas	-13.9%	-14.6%	-11.0%	-12.2%	-12.8%	-15.7%
Rocky Mountain						
Colorado	-7.9%	-9.9%	-4.7%	-3.7%	-7.1%	-12.4%
Idaho	-5.4%	-6.4%	-4.7%	-4.0%	-5.2%	-4.7%
Montana ^c	-	-	-	-	-	-
Utah	-6.5%	-11.2%	-6.7%	-4.0%	-2.6%	-10.0%
Wyoming	-11.8%	-11.0%	-6.5%	-12.0%	-11.0%	-13.2%
Far West						
California	-5.9%	-11.2%	-7.1%	-4.7%	-1.4%	-7.7%
Nevada	-12.0%	-12.6%	-9.1%	-11.1%	-12.6%	-12.6%
Oregon	-3.0%	-9.4%	-1.0%	-1.9%	1.6%	-6.5%
Washington	-12.1%	-13.0%	-7.5%	-10.3%	-11.6%	-16.7%
Alaska	-15.0%	-11.7%	-8.9%	-13.2%	-15.0%	-17.7%
Hawaii	-5.0%	-11.0%	-6.8%	-5.1%	-1.2%	-5.0%
United States	-9.2%	-11.6%	-8.1%	-7.8%	-6.7%	-11.2%

	-8.5%	-18.4%	-5.8%	-7.9%	-5.9%	-7.0%
	-10.2%	-20.0%	-10.3%	-9.6%	-5.1%	-7.7%
	-8.3%	-14.8%	-6.0%	-7.8%	-6.7%	-6.5%
	-10.5%	-22.8%	-11.2%	-10.8%	-7.4%	-8.4%
	-7.1%	-13.6%	-5.4%	-5.6%	-6.4%	-6.7%
	-6.2%	-10.6%	-5.3%	-7.4%	-5.7%	-0.5%
	-8.6%	-18.3%	-8.1%	-7.8%	-5.3%	-6.0%
	-7.5%	-16.7%	-4.3%	-8.8%	-5.7%	-4.8%
	-7.5%	-18.4%	-6.9%	-6.4%	-4.6%	-6.8%
	-9.6%	-20.0%	-4.5%	-8.4%	-7.9%	-6.2%
	-6.5%	-14.9%	-3.5%	-6.3%	-4.6%	-5.4%
	-9.6%	-17.9%	-6.7%	-8.7%	-7.9%	-10.5%
	-8.1%	-13.7%	-7.2%	-7.1%	-7.5%	-8.3%
	-7.8%	-16.2%	-8.1%	-8.5%	-6.4%	-2.6%
	-9.6%	-18.4%	-8.9%	-9.2%	-7.1%	-8.3%

*The percent changes are based on the total federal individual income tax liabilities of all taxpayers in a given income class and, therefore, represent the average change in liabilities for all taxpayers of a particular income class. The tax liability of any one taxpayer, however, will depend on many factors unique to that individual and may vary substantially from the average change in taxes paid by all individuals in the same income class. Federal adjusted gross income is used to define income class.

THESE NUMBERS ARE PRELIMINARY AND SUBJECT TO CHANGE.

^aThe estimated decline in taxes for the entire nation, of approximately 9%, overstates the nationwide tax reduction by about 25%, or roughly 2 percentage points in the case of each reform proposal (see below). Because of modelling and data limitations, it is not possible to make a corrective adjustment for each state. These preliminary estimates are based on microsimulation modelling of the federal income tax code by deSeve Economics Associates. The deSeve data base is conceptually the same as that used by the U.S. Department of the Treasury and the Joint Tax Committee for analysis and revenue estimates of federal individual income tax changes. The number of records in the deSeve data base, however, is substantially larger and, therefore, permits the calculation of meaningful results at the state level. The Administration's (February 1985) economic forecasts of the national economy were used to expand the data base. All estimates are based on 1986 projected levels of income and are designed to present the fully phased-in effects of all provisions of the tax reform plans. It is important to note that the figures supplied by deSeve Economics overstate the decline in federal individual income tax liabilities because certain tax provisions cannot be captured by microsimulation techniques. For each plan, approximately 98% of the revenue-losing provisions and 73% of the revenue-gaining provisions are covered by these simulations.

^bThis weighted average includes the income class of less than \$10,000 that is not included on this table. The nationwide decline in federal income tax liabilities for this income class under the President's plan and the House plan would be -57.7% and -76.8%, respectively.

^cThe estimated data for this state are not yet available.

SOURCE: ACIR staff compilation based on data provided by deSeve Economics Associates. This research was funded in part by the Ford Foundation.

Note: These estimates may vary from other sources for several reasons. Estimates of the effects of proposed changes in the federal tax code may be based on economic forecasts from different sources and may be updated routinely due to changing economic conditions. In addition, the estimates presented here are designed to show the fully phased-in effects of all provisions of the tax reform proposals even though some have grandfather clauses or would not be fully phased-in until years subsequent to 1986.

And Briefly: Books

Kelly McManus
Information Officer

SPECIAL NOTE

An errata sheet has been prepared for tables appearing in *Fiscal Disparities, Central Cities and Suburbs*, published in 1984. Most corrections relate to aid figures for Philadelphia and the East Region. Copies of the errata sheet may be obtained from ACIR Publications, 1111-20th Street, N.W., Washington, D.C. 20575.

State and Local Taxation of Out-of-State Mail Order Sales (A-105), \$5.00

Should a state have the authority to levy sales and use taxes when its residents purchase goods from out-of-state mail order vendors? This is a central question addressed in ACIR's recent report entitled *State and Local Taxation of Out-of-State Mail Order Sales*.

In *National Bellas Hess vs. Illinois Department of Revenue*, the U.S. Supreme Court ruled that a state cannot require out-of-state firms to pay sales and use taxes if their business presence in that state is limited to distributing sales catalogues or other forms of advertising. To do so would place an undue burden on interstate commerce. Because sales and use taxes are a primary source of revenue available to state governments, states want the authority to tax these mail order sales.

The report examines the arguments from the perspectives of both the states and the business community in depth. It addresses the problems related to enforcing sales and use tax collection, and contains estimates of lost state revenues and compliance costs.

The Commission's recommendation for dealing with the problems posed by the mail order issue seeks to strike a balance between two conflicting and perennial concerns of

our federal system—the maintenance of a free flow of interstate commerce and the retention of strong and equitable state revenue systems. In response to interstate commerce concerns, the Commission recommendation provides safeguards designed to minimize the compliance burden on out-of-state mail order firms. In protecting the integrity of state revenue systems, the recommendation enables states to collect more than 70% of the estimated \$1.5 billion which currently escape sales taxation, while exempting some 6,000 mail order firms nationwide.

1983 Tax Capacity of the Fifty States (M-148), \$10.00

For over 20 years, a series of ACIR information reports has emphasized both the inadequacies of per capita income as a measure of the revenue capacity of the 50 state-local fiscal systems and the need for building a better yardstick for making that measure. ACIR's earliest report on the subject dates back to 1962: it was the first to present an alternative—the Representative Tax System (RTS)—for measuring state tax capacity.

ACIR's most recent report on the RTS, *1983 Tax Capacity of the Fifty States*, defines the RTS measures of tax capacity and tax effort, and provides a step-by-step description of the RTS methodology. The report also contains an analysis of the 1983 estimates of tax capacity. The last section "Experimental Modifications to the RTS Method" illustrates its adaptability.

There are a number of tables and appendices in the report. Appendices A and B present detailed state-by-state and tax-by-tax data on tax capacities, tax revenues, and tax efforts for 1983. Appendix

A is organized by state, showing graphically the RTS data on tax capacity and effort. Appendix B provides a full set of RTS tables containing the 1983 estimates, devoting a table to each of the 26 tax bases. Appendix C provides tax base definitions and explanations and cites data sources. Appendix D presents summary RTS tables for selected years prior to 1983.

The Condition of American Federalism (M-144), \$5.00

To help commemorate its 25th Anniversary, ACIR conducted a series of nationwide hearings to examine changes in the federal system, with special emphasis on state-local relations. In all, over 50 elected and appointed officials and representatives from national public interest groups presented testimony.

The first two hearings focused on public finance and tax issues, and government reform. The last three hearings focused on the status of state-local relations and the condition of the intergovernmental system. The speakers, topics, dates and locales are contained in each hearing summary.

There was widespread agreement among the participants in two major areas. The balance of power in the federal system is shifting and will continue to do so. Almost unanimously, it was held that the mounting federal deficit spelled an end to the politics of intergovernmental fiscal expansion at the national level. This situation marks a major reversal in the relative fiscal health of the partners in the American federal system.

Taken separately, the summaries provide a clear understanding of the effect the shift in power and responsibilities is

having on each level of government. . . the problems government officials at all levels are faced with, what they are doing about them, how they plan to generate revenue and provide services. As a whole, *The Condition of American Federalism* focuses on fiscal forces, economic development strategies, and shifts in intergovernmental relationships which likely will be key factors affecting federalism for the remainder of this decade and beyond.

A Framework for Studying the Controversy Concerning the Federal Courts and Federalism (M-149), \$3.00

A Framework for Studying the Controversy Concerning the Federal Courts and Federalism represents the first stage of research in an effort to determine the impact of recent court rulings on state-federal relations. The report serves as a blueprint outlining the scope, direction and issues which require consideration in studying federal court involvement in state affairs.

The report begins by examining federalism in an historical context. It includes arguments between the federalists and anti-federalists regarding the division of authority. Court cases from *McCulloch* to *Garcia* are cited to illustrate how the Supreme Court has dealt with questions of state-federal jurisdiction, and how the Court arrived at its current level of involvement in restricting certain actions of state governments and prescribing certain standards to which they must adhere. The report also focuses on the various means by which the Court has expanded the content and meaning of individual rights.

A concluding section identifies a set of central research questions designed to organize empirical studies of federal court involvement in several policy areas.

Reflections on Garcia and Its Implications for Federalism (M-147), \$3.00

In an effort to explore the broad context of the Supreme Court's decision in *Garcia v. San Antonio Metropolitan Transit Authority*,

ACIR has published an information report, *Reflections on Garcia and Its Implications for Federalism*.

The ACIR staff analysis suggests the following interpretation of the present situation: (1) that the decision of the Court in *Garcia* may be reasonably correct in its construction of what the Constitution today requires; (2) that this construction is nevertheless inconsistent with the preservation of federalism; and (3) there emerges, therefore, a basic contradiction between (a) the common belief that the Constitution establishes a federal system and (b) the result produced by well-established conventions of constitutional law.

The report concludes by suggesting both a range of possible state responses to *Garcia* and a variety of approaches to constitutional reform by means of the amendment process.

Devolving Federal Program Responsibilities and Revenue Sources to State and Local Governments (A-104), \$3.00

Noting that decentralization is an enduring value in the American system of government, the Commission has recommended that consideration be given to turning back selected federal government programs to states and localities, along with tax sources to finance them. The recommendation is contained in *Devolving Federal Program Responsibilities and Revenue Sources to State and Local Governments*.

A turnback package is defined as legislation that would simultaneously repeal federal aid programs and relinquish tax bases (such as excises on alcohol, tobacco and gasoline). States would then be in a position to levy these taxes and use the revenue to fund the programs at the state and local levels.

The Commission did not recommend any specific legislation. However, included in the report are five possible ways the federal government could give serious consideration to turnbacks. The five turnback options involve \$10 billion, \$17 billion, \$18 billion, \$21

billion, and \$22 billion in programmatic authority, and would replace 98%, 91%, 84%, 88% and 84% of the revenues in excise taxes, respectively. The Commission also adopted a national interest test that lays out criteria for assigning which program should remain at the national level and which should be devolved to the states.

Significant Features of Fiscal Federalism, 1985-86 Edition (M-146), \$10.00

During the past 27 years, ACIR has analyzed a large body of information pertaining to federal, state and local fiscal relations. *Significant Features of Fiscal Federalism*, one of ACIR's most popular publications, presents updated information on federal, state and local revenues, expenditures, tax rates, employment, earnings, and selected additional topics. These data are helpful to anyone analyzing the 50 state-local fiscal systems and that of the national government.

Section I presents historical and state-by-state information on specific public finance topics. It is organized to highlight historical trends and regional comparisons. Section II—a new addition—contains rankings on specific state-local revenue and expenditure items. Section III is organized to aid in detailed analyses of public finance statistics within selected states. It also contains data on local government subunits within each state, aggregated at the state level for the particular type of government.



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