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Intergovernmental PERSPECTIVE

Summer 1991, Vol. 17, No. 3

Taking Federalism Underground: Managing Water Resources
William Blomquist

Grant Reform Reconsidered
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ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

A View from the Commission

Intergovernmental cooperation is one of the fundamental principles of the National Transportation Policy, announced by President Bush in March 1990. That policy is the nation's strategic vision to help prepare America's transportation systems for the competitive challenges of the 21st century. With all sectors of government pulling together, we can help put America's best foot forward as we prepare for a highly competitive world marketplace in the 21st century.

Fortunately, we see ample evidence that the country is adopting the battle cry for intergovernmental cooperation in transportation and is beginning to build on the foundation set forth in our policy.

First, the Congress embraced intergovernmental cooperation when it enacted the *Airport Capacity Act of 1990*, the most important piece of aviation legislation since deregulation in 1978. It gives local airport authorities a financing mechanism that will permit them to expand capacity to meet expected air traffic demands of the 21st century. The Congress allowed local airports to charge a passenger facility charge, a fee on each departing passenger, to raise revenues for badly needed capacity expansion.

Second, local airports and state and local governments then began working with federal officials and U.S. airlines to hammer out an acceptable rule that governs how that passenger facility charge will be collected and administered. That rule is now in place, and the FAA and airports are moving to plan for present and future capacity needs.

Third, we've seen local seaport authorities sitting down with federal highway, rail, and hazardous materials officials for the first time, crafting innovative solutions to critical problems of land-side access to our seaports. Successive meetings and studies are leading the effort to relieve congestion around America's ports, which are important not only to our national security, but to our ability to compete in an increasingly competitive global economy. And in the process of solving the problem of land-side access for trucks and trains to our seaports, we will ease another pressing problem for the average motorist—highway congestion.

Fourth, we've seen officials of the Environmental Protection Agency and federal and state highway officials sitting down in a kind of summit to hammer out agreements on how to preserve our wetlands, protect our environment and still meet pressing transportation needs.

Fifth, under the aegis of the National Transportation Policy, we've seen officials at all levels of government in all modes of transportation sitting down at the department's two Traffic Safety Summits to work out details to lower the death rate on our highways.

However, the biggest test of intergovernmental cooperation is in the *Surface Transportation Assistance Act* now being debated in the Congress. The Administration's bill offers the best balance between demands and responsibilities on the federal government and on state and local governments.

Our approach to surface transportation is the same as that driving our approach to aviation. We recognize that transportation is the key to America's success in meeting the competitive challenge of the global economy of the 21st century. Our surface transportation reauthorization bill sets forth two fundamental pillars that support our overriding goal of enhancing U.S. competitiveness. At the same time, it strikes a clear intergovernmental balance.

The first pillar is national in scope and will ensure the efficient movement of people and goods from shore to shore and border to border. That pillar is our proposed 150,000-mile National Highway System (NHS), which largely consists of existing highways, including the 43,000-mile Interstate System. A national highway system carries 75 percent of intercity truck traffic, and 450 percent of all U.S. travel on only 4 percent of public road mileage. The Interstate System has served us well, but since its inception in the 1940s, new population centers have grown up and our travel patterns have changed. The NHS would reflect those changes and represents an *essential* component of an efficient transportation system.

Our bill also includes a local component geared to ensuring the best solutions for regional transportation problems. It involves greater state and local investment, coupled with greater flexibility for state and local management of federally assisted projects.

The Administration's bill provides for a great deal of flexibility in the use of both highway and transit funds. In the urban/rural program, if state and local authorities decide mass transit is the best solution for meeting particular needs, up to 40 percent of all federal money provided in this bill can be made available for transit purposes.

With greater flexibility comes greater responsibility. Common sense tells us that a higher level of state and local investment will improve local decisionmaking and management of transportation programs. Where there's greater stake, there's going to be greater accountability.

All in all, our approach marks the beginning of a new era, founded on a renewed need for intergovernmental cooperation. The Advisory Commission on Intergovernmental Relations has always provided a useful vehicle for achieving this cooperation, which is why I have been committed to working with ACIR.

Samuel K. Skinner
Secretary of Transportation
Washington, DC

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Staff
John Kincaid
Executive Director

Joan A. Casey
Pamela L. Reynolds
Co-Editors

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ACIR News

On the ACIR Agenda

The summer meeting of the Advisory Commission on Intergovernmental Relations was held in Washington, DC, on June 28. Following are highlights from the agenda and Commission actions.

Bank Reform Panel

Treasury Department proposals to reform the U.S. banking system, specifically issues such as branching, state tax and regulatory powers, and the too-big-to-fail policy, were discussed by the Commission at its March 22 meeting. One outcome of the discussion was a panel on bank reform, held in conjunction with the June 28 meeting of the Commission.

Participating on the panel were: Diane Casey, Executive Director of the Independent Bankers Association; Robert R. Glauber, Undersecretary for Finance, Department of Treasury; Kenneth W. Littlefield, Texas Banking Commissioner; and John T. Russell, Vice President and Director of Corporate Communications, Banc One.

Preemption Notification Legislation

The Commission adopted draft preemption notification legislation, which stipulates that unless the Congress explicitly declares its intent to preempt state and local government powers and clearly describes the scope of that preemption, no statute can be construed to preempt. The proposed legislation is a response to concern over the frequency and degree of federal preemption of state authority and flexibility in areas of state responsibility.

The legislation has the support of the National Conference of State Legislatures and the Council of State Governments' Intergovernmental Affairs Committee.

Water Governance Group Holds First Meeting

ACIR is convening a senior advisory group on federal-state-local cooperation in water governance to be co-chaired by Governor George A. Sinner of North Dakota and Mayor Robert M. Isaac of Colorado Springs. The group, which held its first meeting on July 17, consists of persons having considerable federal, state, and local government and nongovernmental experience in water issues.

The senior advisory group will solicit ideas from many sources in order to develop strategies to achieve a system of governance that (1) pays maximum attention to the overall adequacy of clean water resources and to effective intergovernmental policies to achieve adequacy, (2) clarifies the rules of water use and the roles of the different public and private water agencies, (3) provides coherence to the activities of federal, state, and local agencies engaged in water governance and management, (4) establishes equitable and timely procedures for resolving the diverse claims made on and for our water resources, and (5) enables those who use and manage water resources to solve problems and help the system adapt to change.

The Western Governors' Association is cooperating and contributing to the advisory group. The group also will coordinate work being done by ACIR with the U.S. Army Corps of Engineers on drought management. It is expected that ACIR will develop recommendations for federal, state, and local action on water governance.

ACIR Reports Shifts in Governmental Spending and Employment

The public sector has continued to expand faster than the economy; government priorities have shifted significantly, particularly in the federal government; expenditure responsibilities have begun to shift from federal to state governments; more states have moved toward centralization of responsibilities relative to local governments; and county and special district governments have become relatively more important.

These are highlights from an information report the Commission has authorized for publication. *The Changing Public Sector* adds a decade of analysis to an earlier study of shifts in direct expenditure and public employment patterns among state and local governments.

ACIR to Study Intergovernmental Effects on Schools

The Carl and Lily Pforzheimer Foundation recently announced funding for ACIR to study the effects of intergovernmental factors in the schoolroom and to host a national conference on the subject.

Over the past three decades, the reach of federal and state governments into the classroom has increased immensely. Civil rights concerns, curriculum reforms, international competition, and the need to equalize per pupil spending have played parts in the rising intergovernmentalization of education. Thus, off-site governments increasingly are using money and mandates to address issues that do not necessarily enhance classroom learning.

At the same time, educational research seems to indicate that the most effective schools are those that can concentrate on the needs of their own students, teachers, parents, and communities. The ACIR study will focus on the extent to which state and federal influences on the classroom may have encouraged or retarded excellence in the education of American children and youth.

ACIR Involved in National Drought Planning

The U.S. Army Corps of Engineers has engaged ACIR in its three-year study of national drought

September Meeting

The next meeting of the Commission will be held on September 12-13, 1991, in New Orleans, Louisiana.

planning processes. ACIR's assignment is to work with the Corps and others to accurately depict the interplay between the American political system and the technical aspects of the water resource planning and management pursued in anticipation of and during droughts. This study will examine diverse institutional influences on water planning and management, such as alternative decisionmaking processes, means of integrating advocacy groups into the process, and procedures for introducing formal risk assessments into the process in a credible and constructive fashion.

ACIR will develop these issues through the use of workshops, and recommend how effective decisionmaking processes can be integrated most appropriately into drought planning and drought response activities, consistent with the American political system.

New Commission Appointments

The following members were appointed to the Commission in April and June: *Ann Klinger* of Merced County, CA; *D. Michael Stewart* of Salt Lake County, UT; Senator *Daniel K. Akaka* (D) of Hawaii; Congressman *Craig Thomas* (R) of Wyoming; and, Congressman *Donald M. Payne* (D) of New Jersey. *James J. Snyder* of Cattaraugus County, NY; *Ted L. Strickland* of the Colorado State Senate; and Congressman *Ted Weiss* were reappointed.

ACIR Staff Changes

Mark L. Glasser is a graduate student at the School of Urban and Public Affairs, Carnegie Mellon and will intern at ACIR this summer. He will prepare reports on the rights set forth in the 50 state constitutions and the provisions for local government, past and present, for the Commission's work on local autonomy.

D. William Graham has joined the ACIR staff as a senior finance analyst. He was previously project manager and financial consultant at the Government Finance Officers Association. He received a Ph.D. in economics at the University of Texas at Austin.

Brenda S. Kemper has joined the staff as a finance analyst. She has a master of science degree from the School of Urban and Public Affairs, Carnegie Mellon University. She will assume responsibility for the preparation of *Significant Features*.

Suzanne T. Spence joined the staff as an administrative secretary. She has a bachelor of science degree from Marywood College in Pennsylvania.

Gregory Watson, an economics student at the University of Chicago, has returned to ACIR as an intern this summer. He will produce the state and local diskettes and provide assistance in the production of *Significant Features, Vol. II.*

State ACIRs Highlights

- The National Conference of State ACIRs will be held in New Orleans, Louisiana, on September 11-12, 1991, in conjunction with the U.S. ACIR meeting. Participants include Commission members, the directors and staff of state ACIRs, and special guests. The conference will be beneficial to those experienced in the work and activities of an ACIR and particularly helpful to those who are newer in the business. It will feature discussions of image, organization, roles, and projects for state ACIRs, as well as a special panel on regionalism.
- The Virginia Local Government Advisory Council has become the Virginia ACIR.
- The New Jersey County and Municipal Government Study Commission is now the State Commission on County and Municipal Government, and was made permanent.
- Craig Zimmers has left the Ohio State and Local Government Commission. Richard J. Platt is the Acting Director.
- John Donaldson, staff person for Maryland's Joint Committee on Federal Relations, retired in June.

Chairman Speaks at the White House

On June 26, Chairman Robert B. Hawkins, Jr., spoke to members of the Council of Independent Regulatory Agencies at The White House. The council consists of the heads of 14 independent U.S. regulatory agencies. The Chairman discussed the Commission's work and spoke particularly about problems of preemption in the federal system today. Copies of his remarks are available from the Commission.

Finance Data Diskettes

1988 Now Available for State-Local Government Finance Data. The diskettes developed by ACIR provide access to Census finance data in a format not previously available, and are designed for easy use. State-by-state data for 129 revenue and 200 expenditure classifications, population, and personal income are included for state and local governments combined, state government only, or all local governments aggregated at the state level.

Format: *Lotus 1-2-3*

Price: $225—Six-year set
$100—FY1988
$60—FY1987
$25 each—FY1986, 1985, 1984, 1983

A demonstration disk for the State-Local Finance Data is available for $5.

State Government Tax Revenue Data, FY1983-87. This diskette makes the state tax portion of the state-local government finance series available six months earlier than the full series. Four years of tax revenue data (FY1983-87) are included on a single diskette. The revenue fields are basically the same as for the state-local series. The state government tax diskette does not contain any information on local governments, nor does it contain any expenditure data.

Price: $60 (for FY83-87 inclusive)

(see page 44 for order form)

Taking Federalism Underground: Managing Water Resources

William Blomquist

The governance of water resources in the United States has raised important issues of intergovernmental relations since the early years of the Republic. From *Gibbons* v. *Ogden* (1824) to *Sporhase* v. *Nebraska* (1982), the U.S. Supreme Court has extended the federal government's power to regulate interstate commerce from transportation on navigable waterways to the withdrawal and use of groundwater. There have been interstate conflicts over the apportionment of surface waters, and conflicts within states over the allocation of water rights in the face of concerns and demands of local governments and federal installations.

The federal government has reserved water rights on all lands set aside for specific purposes (e.g., military and Indian reservations, wilderness areas). This means that the federal government may use whatever waters are needed, at any time, to fulfill the purpose. These water rights are superior to any others allocated subsequently in accordance with state laws, even if the federal rights are unused for decades. Water development projects, especially in the West, have involved the federal government in such issues as the size of farms, have spurred the creation of special districts to function as project contractors, and have given the federal government a spending power with which to condition project authorizations on actions by the states and local governments.

In the past, most water policy and intergovernmental issues focused on surface supplies. Recently, more attention has been directed to groundwater use, which has grown significantly. Groundwater constitutes over 90 percent of the country's potential fresh water supply; supplies part or all of the drinking water for half the nation's population; and accounts for over 20 percent of all water withdrawals, with 33 percent for irrigation and livestock and 15 percent for industrial uses. As a result, the allocation of groundwater supplies and the protection of groundwater quality have become important policy issues.

Groundwater resources are receiving attention for other reasons, as well. Surface water supplies and storage facilities have been developed to a much greater extent (and for a much longer time) than groundwater supplies and are becoming scarce relative to the demands placed on them. Increased efforts to preserve instream flows for recreation, fish and wildlife habitats, and scenic areas also have limited the prospects for developing additional supplies from surface sources. Groundwater supplies, however, are several times more plentiful than surface water. Perhaps most importantly, groundwater basins provide efficient storage and distribution in addition to supply. As a greater percentage of the U.S. population comes to reside in the more arid West, and as environmental and economic considerations inhibit the construction and maintenance of surface water projects throughout the country, the value of groundwater basins has risen to the fore of water management issues.

A broad consensus has developed in favor of making optimal use of resources where possible through coordinated management of surface water supplies and storage with groundwater supplies and storage. Such coordination—known as "conjunctive management"—can increase total water supply, with greater reliability and lower costs, while protecting water quality. However, as communities and regions attempt to implement coordinated use, they engage not only the intergovernmental issues that have characterized surface water development but emerging issues of groundwater allocation, use, and protection.

These trends and issues prompted ACIR to investigate and make recommendations on the roles of the governments in the federal system in managing groundwater supplies in general and the coordinated use of groundwater and surface water in particular. The ACIR report, *Water Governance in the Federal System: Intergovernmental Lessons and Challenges*, documents current and anticipated groundwater

policy, describes cases of coordinated management, examines the institutional barriers to improved water resource coordination, and recommends possible improvements.

Groundwater Management and Use

Groundwater use varies across the United States. The national averages given above mask enormous differences in types of use and dependence. In addition, the groundwater basins underlying most of the country vary greatly in area and depth, soil composition, water quality, and rechargeability. These variations affect the basins' yield and storage capacity, making them more or less amenable to coordinated use, and must be considered in the development of effective management rules.

The variability of groundwater use and basin characteristics renders claims of a "national groundwater problem" requiring a national solution highly problematic. Indeed, it would be nearly impossible, and probably counterproductive, to develop nationwide rules for managing groundwater basins by themselves, much less in coordination with surface water supplies. For the effective coordination of water supplies and storage, the American federal system provides opportunities for devising and implementing diverse and innovative strategies, adapted to specific needs and characteristics, through a variety of institutional arrangements.

State and local governments have initiated most coordinated use strategies, despite increased calls for the federal government to engage in active groundwater supply management. Examples of state and local activity range from centralized state administration of statewide groundwater management laws (e.g., Arizona) to local special district operations in the absence of statewide authority (e.g., California). There also are interstate and interlocal cooperation and coordination. So many innovative and effective approaches have been developed that it is impossible to distill a single organizational model from among them.

Instead, "management" needs to be defined in terms of functions rather than types of organizations. The functions of coordinated use of surface and groundwater resources are: control of overdraft, which involves limitations on water withdrawals and assuring sufficient replenishment; regulation of storage capacity; protection of water quality from degradation; the assignment of costs of management and maintaining adaptability.

Several governmental and nongovernmental bodies may perform these water resource coordination functions effectively. In fact, most such efforts involve complex mixes of public institutions, private water users, and specialist organizations. Interorganizational arrangements include contracting, water commissions, agreements, and stipulated adjudications. Dispute resolution methods include negotiating, bargaining, and adjudication.

Special districts frequently have been part of the arrangements for coordinated use of water resources because their jurisdictional boundaries can be adjusted to communities of interest and to resource boundaries, and because their separate organization increases their financial autonomy, allowing costs to be matched more nearly to beneficiaries. There also has been considerable private entrepreneurship in the water supply field.

Altogether, the many public and private organizational forms and interorganizational arrangements for water provision, management, and regulation have come to constitute a complex "water economy," in which different communities of interest can be defined and represented.

Because the functions have different appropriate scales of operation, all governments have roles to play in improving water supply management. The development of basic research, applied research capability, and the production and dissemination of information are appropriately organized on a national scale, whether through direct federal activity or support of universities, water resource research centers, and associations. Other functions, such as improving institutional capacity for regulation and conflict resolution, creating user incentives through the laws governing water rights and transfers, and providing technical assistance to water managers are appropriately organized by the states. Still other functions, such as water pricing, controlling overdraft, and regulating underground water storage, are organized on a local scale, often by special districts.

Moreover, the appropriate configurations of intergovernmental roles and relationships for protecting water quality may be different from those for allocating water supplies. Coordinated use of surface and groundwater supplies cannot proceed without taking account of quality protection. At a minimum, this means that water quality is not harmed; preferably, it should contribute to protection and enhancement. The leadership role of the federal government in water protection has been, and is likely to remain, greater than that of local governments. The appropriate scale for research on the health effects of contaminants and for establishing standards for drinking water and ambient water supplies also is national.

Removing the Barriers

Despite the extent of activity and innovation in developing coordinated use of water supplies and storage, there still are challenges to be confronted. In some cases, abundant groundwater supplies have been polluted to the extent that they must be left unused. Some state laws allocate water to certain uses while denying it to others. Crops that need great amounts of water are grown in arid areas. Irrigation techniques too often let a high proportion of water escape into the air or ground without benefit. Urban dwellers in some communities fail to conserve water.

The ACIR report identifies some important barriers to more effective water resource management and suggests that the state and federal governments could alter existing arrangements that do not produce incentives for user behavior that is consistent with effective coordination. Most of these barriers are institutional, having to do with rules of allocation and use.

In many states, the laws tie water rights to land ownership, leave rights unquantified, generate disincentives to conserve water supplies and to use underground stor-

(continued on page 24)

Grant Reform Reconsidered

Bruce D. McDowell

In the 1991 State of the Union message, President George Bush proposed that the federal government turn over to the states at least $15 billion of federal grant programs in one large block to help reduce federal administrative costs and increase flexibility for the states. The proposal was included in the President's FY 1992 budget submitted to the Congress.

The states generally expressed a willingness to explore the proposal. Local governments, however, were not positive. Local officials objected to the suggestion that local housing and community development grants be included in the programs to be turned over to the states.

The President noted that the specific programs included in his proposal were illustrative only, and he invited the states to submit suggestions. On April 8, 1991, the National Governors' Association (NGA) and the National Conference of State Legislatures (NCSL) released their block grant proposals. The NGA proposal would create 7 block grants from 42 programs, and the NCSL proposal would create 12 blocks from 85 programs. Tables 1 and 2 compare the most significant features of the three proposals.

Alternative Proposals

The three sets of proposals suggest block grants in seven different program areas, only two of which—education and training, and environmental protection—appear in all three proposals. Neither NGA nor NCSL included housing and community development. NGA omitted criminal justice and transportation. NCSL omitted health and human services—the largest component of President Bush's proposal—while NGA proposed a five-to-ten state pilot program. NGA and NCSL proposed block grants for rural/agricultural programs, and NCSL proposed transportation (neither of these was addressed in the Administration's proposal).

NGA's proposal would consolidate a larger number of existing grants than the Administration proposal, but would involve fewer dollars. The NCSL proposal would involve about twice as many programs as the NGA proposal and about the same amount of funding as the Administration's proposal.

Table 2 compares some of the principles guiding the proposals. NGA and NCSL give more attention than the Administration to program goals and less attention to funding flexibility. NGA and NCSL also call for stable funding in all of the grants, including adjustments for inflation. The Administration incorporates funding reductions or stability without inflation adjustments for all but one of its 11 components.

All three proposals seek to be neutral with respect to the distribution of funds and would significantly reduce regulatory burdens. The proposals differ somewhat, however, in their focus. While the President's proposal made no special distinction among programs with respect to regulatory impact, NGA used the burdensomeness of programs as a criterion. NCSL added provisions for resisting re-regulation (which commonly occurs in block grants over time) and called for reform of the fiscal notes process in the Congress and a new process to help limit federal preemptions and mandates.

Federal Grant Reform

President Bush's turnover proposal is not the first attempt to reform the federal grant system. Such proposals date back at least to the mid-1950s.

In 1953, President Dwight D. Eisenhower appointed a temporary study commission on intergovernmental relations. Eisenhower believed that the federal government

had expanded too far into too many domestic functions, which, until recently, had been left primarily to the state and local governments. Federal grant programs were a major topic of study for the commission.

After analyzing many programs, the commission concluded that continued use of conditional grants with clear national purposes made sense, but that greater flexibility and less rigid restrictions were needed to free up the creative talents of the state and local recipients. Options for (1) a general equalizing grant based on the varying fiscal capacities of the states and (2) the simultaneous reduction of grants and federal taxes were examined at length but rejected in the commission's final report in 1955.

In 1957, Eisenhower formed the Joint Federal-State Action Committee, composed of governors and cabinet officers, to consider a simultaneous reduction of federal grants and taxes. During its two-year life, the committee made several proposals to the Congress, but none were enacted. All of the proposals would have created too many winners and losers among the states and too many doubts about the continuation of programs returned to the states.

Federal block grants were initiated in 1965 when several related categorical programs in the health field were consolidated to provide some of the flexibility recommended by the intergovernmental study commission. Despite a large number of proposals by President Richard M. Nixon, there still were only four block grant programs by 1981, when the first *Omnibus Budget Reconciliation Act* was passed by the Congress. That act raised the total number of block grant programs to 12. It did this by consolidating 77 programs (one of which was a block grant) into 9 new programs. (Three of the preexisting block grant programs were left unchanged.) The new block grants provided greater flexibility for state and local initiative and reduced federal paperwork requirements.

In 1972, a third element was added to the federal grant system—General Revenue Sharing (GRS). This program had no limits on programmatic spending and few other conditions (except civil rights and public hearing requirements). This program, however, was allowed to lapse.

In 1982, President Ronald Reagan proposed a wide-ranging trade of programs in which the states would have taken full responsibility for 43 grant programs in return for $28 billion in federal excise tax reductions (which the states would have been free to reenact if they chose), plus federal assumption of full responsibility for financing health care for the poor (Medicaid). The governors led negotiations with the White House over this proposal for many months. The proposal originally was viewed in many quarters as a federal deficit reduction plan. When the governors sought a revenue-positive or at least a revenue-neutral version, the "swap" proposal fell through.

During negotiations with the White House, analysis focused on the problem of winners and losers among the states—a problem that is easier to address (with hold-harmless provisions, for example) in growing programs than in shrinking ones. In hindsight, the states might have been well advised to accept the "swap" proposal, even with some immediate program cuts, because Medicaid payments subsequently grew rapidly, well beyond what had been expected at the time.

Table 1

Comparison of 1991 Block Grant Proposals: Programs and Funding

Programs	Administration			National Governors' Association			National Conference of State Legislatures		
	Number of Programs Consolidated	Millions of Dollars (FY91)	Number of Block Grants Resulting	Number of Programs Consolidated	Millions of Dollars (FY91)	Number of Block Grants Resulting	Number of Programs Consolidated	Millions of Dollars (FY91)	Number of Block Grants Resulting
Criminal Justice	1	$490		—	—	—	2	$570	1
Education and Training	4*	$1,893		27	$11,201	3	22	$7,085	3
Environmental Protection	1	$2,083		6	$2,551	2	16	$2,684	2
Health and Human Services	5	$9,588		3*	$5,349**	1**	—	—	—
Housing and Community Development	2*	$8,712		—	—	—	—	—	—
Rural/Agriculture	—	—		9	$349	2	27	$1,456	2
Transportation	—	—		—	—	—	18	$9,496	4
Totals	**12***	**$22,766**	**1**	**42**	**$14,101**	**7**	**85**	**$21,291**	**12**

*This number of programs is understated: not detailed in the Administration proposal.

**Recommended only as a pilot program in 5-10 volunteer states. Not included in total.

Source: Advisory Commission on Intergovernmental Relations, May 1991.

Table 2
Comparison of 1991 Block Grant Proposals: General Principles

Issue	Sources of Proposals: Administration	National Governors' Association	National Conference of State Legislatures
Program Goals	Continued from present programs at discretion of the states.	Should be clearly stated for each block grant program; methods of achieving goals determined by the states.	Each block grant program should have common purposes, type of service provided, or clientele served.
Funding Flexibility	Completely determined by the states.	Up to 15% transfer allowed between component block grant programs.	No provision.
Future Funding Levels (over 5 years)	As projected in Administration's FY92 budget: 6 of 11 programs included would decrease, 1 would lapse, 3 would remain stable, 1 would increase.	All programs included should be guaranteed at FY91 levels plus inflation; provisions for certain upward adjustments. Enact a permanent appropriation or entitlement. Waive matching and maintenance of effort requirements when economy turns down.	Enact stable funding with automatic adjustment for inflation—outside the federal spending cap.
Distribution of Funds	Use existing formulas for 5 years.	Initially use current formulas.	Each state should be "held harmless."
Regulations	Would be greatly reduced.	Give priority to including programs with the most burdensome regulations for purposes of reducing them.	Reduce and streamline existing regulations. Remove earmarks. Resist re-regulation and new restrictions. Reform fiscal note process. Enact legislation to limit federal preemptions.

Source: Advisory Commission on Intergovernmental Relations, May 1991.

While helping to negotiate with the White House, Vermont's Governor Richard A. Snelling raised the issue of replacing all or most programmatic federal grants with a single equalization grant to the states. This grant would have been based on the differences in revenue-raising capacities among the states. Snelling reasoned that, if all the states had roughly equal revenue capacities, they would not need federal help to meet their domestic responsibilities, and the federal grant system could be dramatically simplified.

The Purposes of Grants

Until 1965, virtually all federal grants were of the categorical variety—having relatively narrow, federally specified purposes and strict requirements for state and local administration. As block grants and GRS were added, the grant system became more flexible and less burdensome. In the process, however, federal funding tended to diminish. For example, block grants were used in the 1980s to cap and cut the programs folded into them, and GRS never increased to keep up with inflation.

As these innovations occurred and matured, the proportionate shares of spending for each mechanism shifted. Block grants peaked at about 15 percent of all federal grant funding around 1978, and programs that share federal revenues with state and local governments (including General Revenue Sharing as well as the proceeds of mineral rights leases, lumbering fees, and grazing fees) peaked at about 15 percent in the early 1970s. Now that GRS is gone, the remaining shared revenue programs account for less than 2 percent of all intergovernmental aid funds; block grants are a bit over 10 percent; and categorical grants have come back from a low of 73 percent in 1978 to about 88 percent. The number of categorical grant programs, which had peaked at 534 in 1981 and dropped to 392 in 1984, increased to 492 by 1989.

Basic Limits on Grant Reform

The history of grant reforms suggests that:

- Specific goals for program innovation or service command greater commitment than does a less specific goal to support broad purposes of government or to help equalize the fiscal capacities of states and localities. Specific goals imply that new initiatives are being undertaken to solve problems or provide certain services, whereas the more general goals of block grants and revenue sharing risk being interpreted as being too diffuse, unaccountable, unresponsive

to critical needs, and wasteful. The more general programs also tend to shift program responsibility and credit for success to grant recipients who do not have to raise the funds they spend.

- Local governments' concerns about access and equity tend to limit the federal urge to administer most grants through the states. From the federal viewpoint, it is easier to make 50 grants than several thousand. However, many local governments believe they will not be treated fairly or as well by the states. Thus, consolidating grants to states with grants to local governments tends to meet resistance.

- The federal budget process tends to limit the scope of grant reform. Each grant program is within the jurisdiction of a single federal agency and a single set of congressional authorization and appropriations committees or subcommittees in each house. Each grant program also has a unifying theme and purpose. A large multifunctional grant program, therefore, would require special treatment, such as realignment of authorizing and appropriations subcommittee jurisdictions, concurrent consideration by several subcommittees, original jurisdiction by the full appropriations and budget committees, or enactment as part of an omnibus budget reconciliation act.

- When major cross-program grant reforms are made, fiscal and administrative shocks may accompany them. For example, state agencies might have to be reorganized to combine previously separate programs and appropriations. Such shocks would require state legislative action and other potentially time-consuming and difficult adjustments. ACIR has recommended that transition devices be considered to cushion such shocks.

Criteria for Grant Reform

Based on grant reform experiences, ACIR recommended in 1981 that primary candidates for termination, phase-out, or consolidation by the federal government include the following:[1]

- Categorical grant programs that are too small to have much impact or to be worth the cost of administration;

- Programs that do not embody essential and clear national objectives; and

- Programs that get (or could get) most of their funding from state and local governments, or from fees for services, or that could be shifted to the private sector.

ACIR also suggested in 1986 that the following be considered in shifting responsibilities:[2]

- The extent of the decentralization;
- The simplicity of the plan;
- The certainty of the funding;
- The adequacy of future revenues; and
- The effects of fiscal discipline.

In developing his turnover proposal, President Bush used the following two criteria to select the federal programs:

- Programs judged by the states to be of continuing value, but whose federal funding priority is declining; and

- Programs that are candidates for flexible management by the states.

In evaluating the President's proposal and working to refine it, NGA and NCSL used the following guidelines:

- The programs selected should have some broad degree of commonality.

- The programs should be either categorical grants to state governments or project/competitive grant programs in which states currently receive most of the funds awarded.

- Priority should be given to grants that have unduly limiting mandates and overly detailed administrative regulations.

- The programs should generally be national in scope and not primarily benefit certain regions and states.

The main issues that have emerged in discussions of the President's turnover proposal relate to the basic goals, the extent of conditions that might be attached to the programs, the distribution of funds, the future outlook for programs included in the proposal as well as those left out, and the jurisdiction of federal agencies and congressional committees over the programs. They will need extensive discussion.

Conclusion

President Bush's turnover proposal presents an opportunity to revisit grant reform from a new perspective. The urge to improve the grant system is shared widely. The need to improve it has been documented many times. There are many and varied concepts of grant reform, and a substantial amount of experience in applying them. Whatever the pros and cons of the specific suggestions set forth in the proposals, this opportunity should not be lost.

Bruce D. McDowell is director of Government Finance Research at ACIR.

Notes

[1] U.S. Advisory Commission on Intergovernmental Relations, *An Agenda for American Federalism: Restoring Confidence and Competence* (Washington, DC, 1981), pp. 111-112.

[2] _______, *Devolving Federal Program Responsibilities and Revenue Sources to State and Local Governments* (Washington, DC, 1986), pp. 72-75.

State ACIRs: Elements Of Success

Andree E. Reeves

In recent years, more than half of the states have addressed the need for improved state-local coordination and cooperation by establishing a state-local relations body. In 1974, the U.S. ACIR recommended that each state establish a permanent, broad-based advisory commission on intergovernmental relations to serve as a neutral forum for discussing mutual interests and problems.[1] Since that time, the number of such state organizations has increased from 4 to 26.[2] The Commission recently renewed its call for each state to create and sustain an ACIR.[3]

This article outlines some of the factors that seem to make for an effective ACIR. The article is based on survey information provided by the state ACIRs in 1989 and 1990 for a directory[4] and a report on those organizations.[5] Subsequent contacts with the state directors have yielded additional information.

The Basic ACIR Concept

The purpose of state advisory commissions on intergovernmental relations is to provide the states, their political subdivisions, and their citizens with an institutional mechanism that can probe and propose solutions to intergovernmental issues within—and in some cases between—the states. The basic idea underlying a successful ACIR is for it to be a permanent, bipartisan, balanced, unbiased, and broad-based forum for airing intergovernmental concerns, promoting intergovernmental communication, making recommendations to improve intergovernmental cooperation, providing objective research on policy issues, and disseminating information.

Through a broad-based and bipartisan membership, diverse viewpoints can be brought to bear on the difficult challenges facing state and local governments, and workable approaches can be developed for meeting these challenges. Broad-based membership can be achieved through a balanced bipartisan or nonpartisan mix of representatives of the general public, the executive and legislative branches of state government, and all types of local units—counties, cities, and other political subdivisions, such as towns, townships, villages, school districts, judicial districts, and tribal governments, as appropriate to the state. The perspectives represented on the commission should reflect the diverse views and concerns in the state.

Permanent, statutory ACIRs are more likely to be insulated from fluctuating political pressures than are temporary or interim ACIRs, or those that are tied to the interests or success of one person or group. ACIRs established by executive order, for example, risk being transitory and may lack sufficient legislative involvement. Permanence can be emphasized by assigning ongoing functions to the commission, following standard procedures for filling vacancies, and avoiding stipulation of a termination date.

Factors Contributing to Success

Creating an ACIR is the first key step. Once an ACIR is in place, the challenge is to make it work well.

Although they may not all be equally applicable to each organization, several factors seem to contribute to successful ACIRs. They include:

1) Commitment of the membership to the concept and implementation of an ACIR;
2) Diversity of views represented in a balanced fashion;
3) Leadership;
4) Professional and unbiased staff;
5) A constituency;
6) Broad scope of relevant activities;
7) A recognized and clearly useful niche in the state-local system; and
8) Visibility (enhanced by marketing).

These factors are discussed in the following paragraphs.

Commitment of the Membership

A successful ACIR requires a commitment by its members to make it work. Broad-based, bipartisan support at its conception is a good place to start. Whether it is born in the legislature or in the governor's office or in some other arena, the more support it has from others, the better chance it has to succeed.

When their members are committed to working with representatives of all types of governments to research, propose, and work out practical solutions to problems, ACIRs work well. Members show their support by their willingness to participate as well as by their willingness to help secure adequate financial resources to make the organization viable.

Diversity of Views

Ideally, ACIRs function as neutral forums for discussing mutual interests and problems. As such, a diversity of views yields a balanced organization that can make significant contributions to improved intergovernmental relations.

ACIR suggested that such commissions consist of four elected county officials, four elected city officials, two executive officials, three state representatives, and four private citizens. Whatever the composition of a particular state ACIR, it must accommodate diverse perspectives if its expects to be effective in addressing statewide intergovernmental issues. One way of doing this is to strive to be unbiased in both governmental and regional representation. Loss of political and financial support and credibility can occur if the organization is seen as a "mouthpiece" for any one type of government or any one region. Balanced legislative-executive roles in the organization's structure and operation also are important.

Although no one will agree with every recommendation, an ACIR is strongest when its perspective reflects the views and interests of all its members. If the commission's decisions or recommendations predominantly represent the state's perspective, the local representatives may believe that their concerns are not receiving sincere attention. If the commission usually sides with the governor, the legislators may disassociate themselves from it and local members may lose interest. If the local view commonly prevails, state support and participation may wane. In short, operating a state ACIR can be a delicate balancing act, but the more it can do this, the more likely it is to make positive contributions to state-local relations, which is the real balancing act.

Leadership

Commission members must be willing to take the lead in trying to work out solutions to intergovernmental problems. They also must be willing to push for implementation of recommendations.

Ostensibly, the members of the commission represent the views of officials in similar positions across the state and are able to show their counterparts the merits of commission recommendations. Therefore, it is wise to include as members the influential public and private sector leaders who can give clout to recommendations. They can seek out other public and private leaders to help implement these recommendations.

These leaders also can ensure that the ACIR is in the mainstream of decisionmaking, particularly concerning budgets. Many critical decisions affecting intergovernmental relations are made during the budget process, and it is important that ACIRs contribute to this process with practical recommendations and reliable information.

Staff

A professional staff with adequate resources can contribute a great deal to the successful operation of an ACIR. The staff can collect data, conduct research, draft legislation and policy statements, work with commission members to devise options that would address intergovernmental problems, and produce reports valuable to commission members and the general public. A professional staff conducting impartial research gives credibility and continuity to the organization.

An evenhanded staff responsive to the interests of all commission members can be particularly useful in maintaining a delicate balance among state, city, and county officials as well as legislators and executives.

Scope of Activities

Successful ACIRs conduct a broad range of activities, though not so many as to spread themselves too thinly. These activities need to be relevant to the needs of the constituent governments, businesses, and citizens. An ACIR out of the mainstream runs the risk of having its statute or executive order repealed or losing its members' attention.

As an open-ended forum for discussion, state ACIRs conduct research on a variety of issues important to their constituents, develop and advocate policy recommendations, and formulate legislative proposals. Increasingly, the state ACIRs are serving as clearinghouses for information on intergovernmental issues and are maintaining large computer data bases for use by state agencies, the legislature, and local governments. Several ACIRs publish a general newsletter, and others provide services and technical assistance tailored to specific constituencies. More and more ACIRs are holding conferences and seminars to train, inform, and set up networks of state and local officials.

Find a Niche

Within its broad scope of activities, an ACIR can contribute to its viability by creating a unique niche. For example, some ACIRs catalog state mandates to local government. Others maintain data banks on local government finances or on federal and state funds available to local governments. A steady stream of high quality reports relevant to the needs of the state's governments, businesses, and citizens also cultivates a stable and supportive commission constituency. Filling such a niche with services not available elsewhere will develop a natural constituency to sustain the ACIR through the inevitable policy controversies and tight budgets it will face from time to time.

Marketing

To ensure that the commission's recommendations are considered and that public support is maintained, many state ACIR members and staff engage in marketing and public relations. An ACIR has many opportunities to market its products. These include conducting hearings and seminars; testifying at legislative hearings; speaking before civic groups; informing citizens; consulting with elected officials, local governments, and state agencies; submitting reports; drafting and disseminating statutes

(continued on page 24)

Fiscal Disparities in Chicagoland

Robert W. Rafuse, Jr.

Interest in decentralized government is flourishing around the world. The appeal of decentralization is multifaceted, but its popular acceptability may well hinge on the question of fiscal disparities. It is no coincidence, after all, that the most prominent theme of debates on local government finance in recent decades has been implicitly or explicitly fiscal disparities. Neither is it an accident that the most weighty arguments for shifting responsibilities from local to state and federal governments have turned on asserted disparities between central cities and their suburbs, among school districts, and less frequently between urban and rural areas.

This article reviews the rationale for decentralizing government, explores the nature and sources of fiscal disparities and the reasons why their existence challenges the legitimacy of a decentralized fiscal system, and presents some new estimates of disparities in the Chicago metropolitan area.[1] This six-county region, referred to by the local media as "Chicagoland," has the world's most complex system of local government, exemplified by its more than 1,200 jurisdictions with authority to levy property taxes.[2]

Why Decentralize Public Finance?

Decentralized government is highly valued in the United States and is being sought with enthusiasm unimaginable a few years ago in nations as diverse as South Africa and the Soviet Union. Decentralization deserves this attention for a variety of reasons. Among the most important is that it sets the stage for intergovernmental competition, which promotes innovation in service design and delivery and creates powerful incentives for efficient performance.

The preeminent rationale for decentralization, however, is that it offers the best prospect for government that is responsive to the diversity of people's preferences for public services. It follows that a decentralized system can be expected to display real variation among localities in spending levels and tax burdens, reflecting the desires of some for a rich variety of public services and those of others for a more modest public sector.

The viability of a decentralized fiscal system in the long run depends on the exercise of restraint by local governments. This means concentrating on services that can only be provided by government because those who do not pay cannot be prevented from enjoying the benefits (so a private firm could not make a profit producing the services) and on providing—or subsidizing private provision of—services the private sector would produce in smaller quantities than people would be willing to pay for. None of these services is intrinsically different from those provided in the marketplace.

The market allocates goods and services by consumer demand: those who pay acquire the right to the benefits from the things they purchase. If this is fair, it follows that the same linkage between benefits and payments should apply in the local public sector. In a word, the financing of local services should be governed by the "benefit" principle, that is, taxes (or fees and charges, when such financing is practicable) should be selected whose incidence is associated as directly as possible with the distribution of the benefits from the services.

Efforts by local governments to rely on "ability-to-pay" rather than benefit finance are almost certain to be self-defeating in a society with free mobility. Those perceiving their taxes to be out of line with the value of the services they receive will seek more favorable terms in other localities. Persons enjoying services for which their tax liabilities are disproportionately low will move into the community. Such patterns of mobility hold little promise for the sustainability of ability-to-pay financing. Mobility is the reason why there is no support in the literature for local fiscal responsibility for such services as welfare programs, which have the worst possible benefit-tax ratios for some and the best possible ratios for others.

Decentralization's Achilles' Heel: Fiscal Disparities

To the extent that variation in tax burdens among communities is roughly commensurate with the variation in the levels of public services the residents of each enjoy, the welfare-maximizing potential of decentralization has the prospect of being attained. This relationship between tax burdens and service levels can be referred to as the "tax price" of public services.[3] When commensurability of tax burdens and services prevails, the tax price of local public services can be said to be roughly equivalent throughout the fiscal system.

It is important to understand that tax prices are not tax rates. High rates may signify nothing more than that a community's voters prefer an expensive mix of public services. The possibility of such differences in tax rates is, of course, a principal rationale for decentralization. In other words, tax prices cannot be identified by observation of actual tax rates.

When tax burdens are not in general balance with service levels (when tax prices differ among communities), the lack of commensurability manifests itself in two ways:

1) Taxpayers with comparable incomes living in different jurisdictions are saddled with disparate tax burdens to finance similar levels of public services, and

2) Taxpayers similarly burdened by local taxes are enjoying different levels of services.

There are two general reasons why these disparities in the tax prices of public services are undesirable: they are inequitable and they may impair economic efficiency.

Most Americans presumably would agree that the prices of local public services should not differ substantially from community to community for reasons beyond the control of local officials. Other things equal, why should the tax price for curbside, once-a-week trash collection in my community be higher than it is in the nearby community where my friend lives? If I want twice-a-week collection, and he is content with once-a-week, I clearly should be prepared to pay more, but I shouldn't have to pay much more for the same service.

The reference to variations beyond the control of local officials is important because cost differentials attributable to differences in operating efficiency are not at issue here. If my taxes are higher than my friend's because public services are delivered less efficiently in my community, that's my problem. My recourse is to exhort my elected officials to be more efficient.

Differences in tax prices are also undesirable if they impair the overall efficiency of the economy. This may happen because differences in tax prices like those in such market prices as apartment rents provide incentives for people and businesses to move to places with lower prices. Sometimes such moves make the economy more efficient; sometimes they don't. Whether tax-price differentials improve or impair efficiency depends on whether they are rooted in the cost or the revenue side of a local government's finances.

When differences in tax prices reflect variation in the real cost of a given level of public services, the efficiency of the economy is promoted. The overall output of the economy would be reduced if the differences were eliminated. Clearly, this case is a classic example of the conflict between efficiency and equity considerations that bedevils policymakers in so many situations.[4]

Alternatively, differences in tax prices may reflect disparities in the income and wealth of communities. Higher taxes are necessary in a poor than in a rich community, other things equal, to finance a given level of public services. These differences also provide incentives for people and firms to move to lower price jurisdictions—or, as it has been said, the poor to chase the rich. In this case, however, the movement does not improve the allocation of resources; on the contrary, it undermines economic efficiency. Hence the tax-price differentials serve no constructive economic purpose, and a policy designed to eliminate them would involve no conflict between equity and efficiency.

The Sources of Fiscal Disparities

Differences in tax prices are the result of significant differences, commonly referred to as fiscal disparities, in the fiscal capacities of local governments. Fiscal capacity is the potential ability of the governments serving an area to raise revenues from their own sources relative to the costs of their service responsibilities, allowing for the revenue they receive from other governments. Because fiscal capacity relates to potential rather than to actual behavior, the sine qua non of measures of revenue-raising ability and service costs is that they abstract from the actual policies of any particular government.

The potential of the governments of an area to raise revenue from their own sources depends on the health of the area's economy: on the income of its residents, the value of the real property located within its borders, and other potentially taxable economic stocks and flows. For local governments, revenue-raising potential also depends on the sources of revenue they are authorized to tap by their state government.

The relative costs of the service responsibilities of local governments, commonly referred to as "needs," are best measured by reference to the cost of a standard level of public services. This cost depends on three general classes of factors:

- The range and types of services jurisdictions must, by law, provide;
- Factors that determine the scope of the services that must be provided, such as the number of school-age children to be educated and the mileage of roads that must be maintained; and
- The unit costs of the inputs used to produce the services, such as the wages and salaries of public employees and the prices of gasoline and computer diskettes.

The Representative Approach to Measuring Fiscal Capacity

The estimates of fiscal disparities in the Chicago region presented in this article are developed using "representative" analysis. This approach asks, essentially, what revenues would be raised and what costs incurred if the

governments serving an area all had a representative fiscal system. The principal advantage of the approach is that it avoids the disputes that would arise if the analysis were based on normative standards.

A key step in representative analysis is identification of the governments whose fiscal behavior is used to define "representative." Most representative analyses take the fiscal system of all state and local governments in the U.S. as the standard. In this article, the reference is to the actual revenue system and spending policies of all local governments in the six-county Chicago area.

No parcel of real estate in the region is served by a single local government. Every inch of the area is served by a county government. Every locality but Chicago is served by a township, and most areas are served by a municipal government, one or more school districts, and several special districts. To structure the analysis and tailor its scope to the resources available for it, the focus is on a representative sample of 40 of the 260 municipalities in the six-county area. The 40 municipalities, with 53 percent of the area's population, are served by 345 local governments. For analysis of the fiscal capacity of an area, the structure of government serving it is of no consequence; hence governmental structure receives no further attention in this article.[5]

Estimating Revenue-Raising Ability. The representative approach estimates the revenue the governments serving an area would collect if their fiscal systems consisted of taxes and tax rates, fees, and user charges typical of those actually in use. The estimates indicate the governments' potential to raise revenue from own sources, without regard to whether and at what rate they rely on any source.

Specifically, estimates are calculated of the yields from 10 separate categories of revenues from own sources if the governments serving the 40 municipalities were to exert the representative level of effort for each type.[6] The actual revenues of each entity from the federal, state, and other local governments are taken as given in the analysis.

Estimating the Cost of Service Responsibilities. The estimates of representative expenditures are what it would cost the local governments serving each of the 40 municipalities to provide a standard set of public services. The estimates relate the underlying socioeconomic and demographic factors that determine expenditure needs to the average policies of local governments in the metropolitan area.

The key step in calculating representative expenditures is identifying a workload measure for each function. The measure is intended to indicate the approximate scope of the service that must be provided the relative "need" for the service in a municipality.[7]

Three important assumptions underlie the estimates. The first is that all local governments in the region operate at comparable efficiency. In other words, the real resource cost of producing a unit of each service is the same throughout the area. Second, the estimates assume that the average cost of producing a service is constant: that there are no economies or diseconomies of scale.

Finally, the estimates assume that the prices of the goods and services local governments buy do not vary significantly around the area. This may be the most troublesome assumption of the analysis because, even within the Chicago area, variation in such factors as property values means that a dollar of spending by a local government in still-rural McHenry County buys more than a dollar in thoroughly urbanized Cook County. Unfortunately, an appropriate index of prices is not available, so it is impossible to determine the extent to which fiscal disparities in the region may be misrepresented as a result of this assumption.

Estimates of Fiscal Disparities in the Chicago Metropolitan Area

Table 1 presents three measures of the fiscal capacities of the 40 municipalities in the sample. Each measure combines an index of revenue-raising ability with an index of the costs of fiscal responsibilities (representative direct expenditures).

The two basic indices in columns 1 and 4 are combined in column 5 to form the first measure of fiscal capacity. They are combined by dividing the index of own-revenue-raising ability in column 1 by the index of representative expenditures in column 4 (and multiplying the result by 100). Because revenues from the federal and state governments are disregarded, the measure of "own" fiscal capacity in column 5 is a useful baseline for considering the effects of federal and state policy. In essence, it shows the disparities in fiscal capacities that would prevail if there were no federal or state payments to local governments.

The fiscal capacities range from a low of 45 in Sauk Village to a high of 334 in Lake Forest. (The estimates for the five municipalities with the highest capacities and the five with the lowest are shown in Figure 1; the first bar in the set for each municipality shows its "base" fiscal capacity, that is, abstracting from federal and state grants-in-aid.) In both cases, the municipalities' indices of revenue-raising ability and service costs compound. That is, Sauk Village has far below average revenue-raising ability (47) and moderately above average costs (105), which compound to produce a fiscal capacity that is lower than is observed when service costs are not taken into consideration.

Although having neither the weakest revenue-raising ability nor the highest service costs, Chicago also suffers from a compounding of disadvantageous circumstances. The city's own-revenue-raising ability is only 80 percent of the six-county average, but its per capita cost to deliver areawide-average services is 111 percent of the average. The result is a fiscal capacity of 72 (80/111). Lake Forest, on the other hand, is blessed by way above average revenue-raising ability (309) to finance below average service costs (92). As a consequence, the fiscal capacity of Lake Forest is significantly stronger than its revenue-raising ability alone suggests.

When federal grants-in-aid are brought into the picture (continuing, for the moment, to ignore state grants), the index of revenue-raising ability becomes that shown in column 2.[8] The federal funding moves the revenue-raising abilities of 28 of the 40 municipalities toward the areawide average. More specifically, federal aid reduces the indices of 24 of the 25 municipalities with own-revenue-raising abilities higher than the areawide average, while it raises the indices of only 4 of the 15 municipalities with below average potential for raising revenues from their own sources. This means, of course, that federal aid relatively disadvantages the situations of 11 of the 15 poorer municipali-

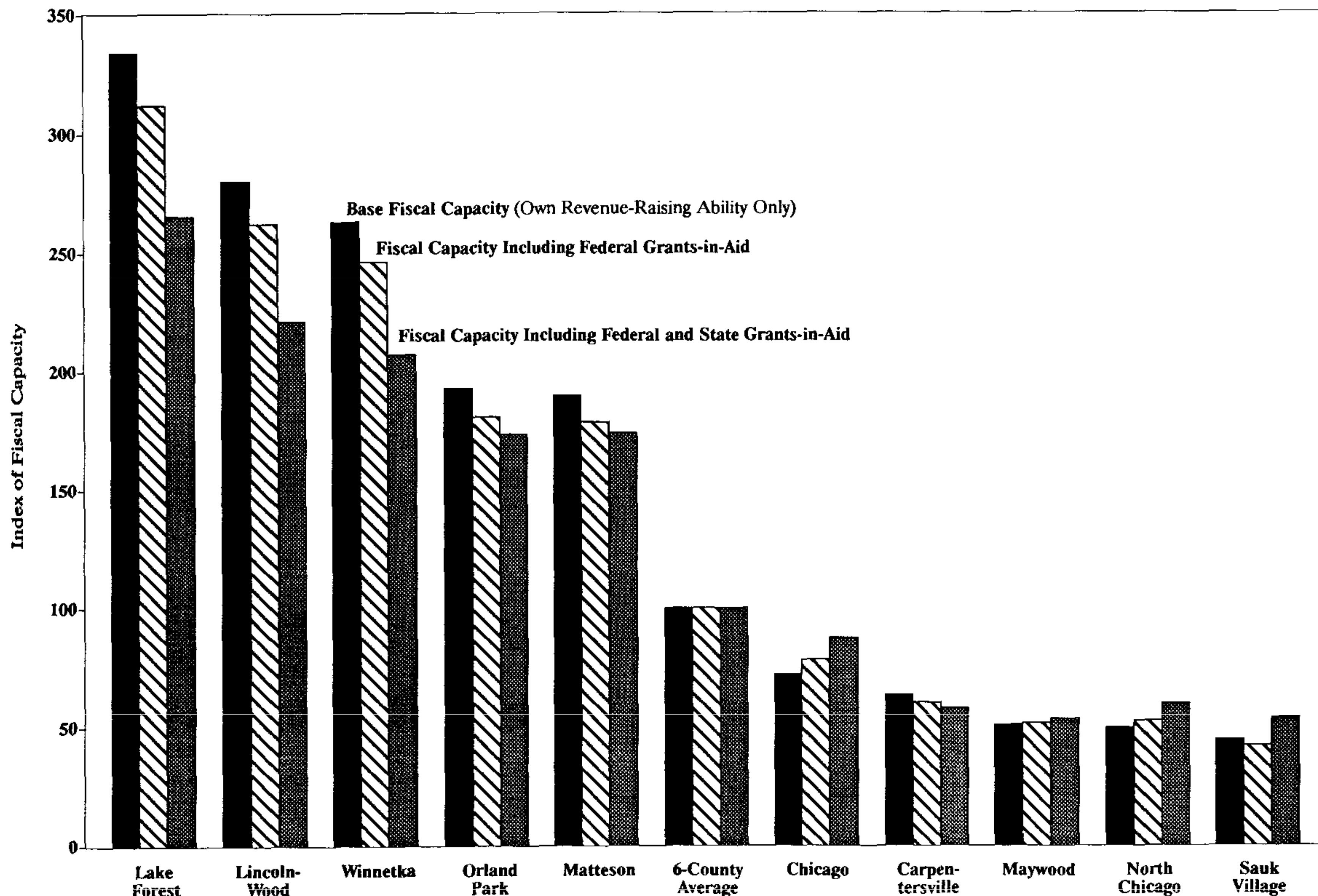
Table 1
Estimates of Fiscal Capacities with and without Federal and State Grants, Selected Municipalities in the Chicago Metropolitan Area, 1987

Municipality	Index of Representative Revenue-Raising Ability: Own-Source General Revenue (1)	Own plus Federal Grants (2)	Own plus Federal and State Grants (3)	Index of Representative Direct Expenditures (4)	Index of Fiscal Capacity: (1)/(4) (5)	(2)/(4) (6)	(3)/(4) (7)
Six-County Area	**100**	**100**	**100**	**100**	**100**	**100**	**100**
40-Municipality Sample	**88**	**92**	**98**	**106**	**83**	**87**	**92**
Cook County							
Bellwood	73	70	69	92	79	76	75
Berwyn	92	86	79	79	115	109	99
Burbank	76	72	62	90	85	80	68
Chicago	80	87	97	111	72	78	87
Dolton	81	76	75	86	95	89	88
Evanston	117	112	100	85	138	131	117
Evergreen Park	118	110	96	82	144	135	117
Justice	71	66	65	81	87	82	80
Lincolnwood	234	219	184	83	280	262	221
Matteson	176	166	162	93	190	179	174
Maywood	58	58	60	113	51	52	54
Norridge	131	123	106	79	165	155	133
Oak Park	104	100	95	88	118	114	108
Orland Park	179	168	161	93	193	181	173
Palatine	125	118	103	94	132	125	109
Palos Hills	93	87	79	86	108	101	91
Sauk Village	47	44	56	105	45	42	54
Schiller Park	145	137	123	94	155	146	131
Westchester	115	108	95	80	144	135	119
Wheeling	157	147	129	84	186	174	153
Winnetka	251	235	198	96	263	246	207
DuPage County							
Bensenville	162	154	132	89	183	174	149
Glendale Heights	93	87	83	92	101	95	91
Glen Ellyn	151	142	123	90	168	158	137
Villa Park	125	123	106	90	139	137	118
Warrenville	106	100	94	82	130	122	116
West Chicago	120	146	129	92	130	158	140
Wheaton	131	123	106	85	154	144	124
Kane County							
Batavia	114	108	100	90	126	119	111
Carpentersville	63	60	58	100	64	60	58
Geneva	155	146	128	91	171	160	140
Lake County							
Gurnee	166	158	140	94	176	168	149
Lake Forest	309	288	245	92	334	312	266
North Chicago	45	47	54	90	50	53	60
Zion	131	123	115	106	124	116	108
McHenry County							
McHenry	127	118	109	88	145	135	124
Woodstock	117	110	100	88	133	125	114
Will County							
Bolingbrook	73	68	80	95	77	72	84
Lockport	94	96	105	89	106	108	118
Romeoville	76	72	79	102	75	70	77

Sources: See text.

Figure 1

Fiscal Disparities in Chicagoland, before and after Federal and State Grants, 1987



ties. The most notable of the four poorer municipalities whose revenue-raising potential is improved by federal aid is Chicago, whose index jumps from 80 to 87.

These effects of federal aid on revenue-raising ability are paralleled by changes in the indices of fiscal capacity when they are recomputed using column 2 as the numerator rather than column 1 (see column 6). For the five highest and lowest municipalities, the indices are shown in the second bar of each set in Figure 1. The fiscal capacity of Chicago, for example, improves from 72 to 78 when federal aid is considered, while Lake Forest's declines from 334 to 312.

When revenues from Springfield are added to the picture, the indices of revenue-raising ability become those in column 3.[9] Of the 23 municipalities with column 2 indices exceeding 100, those of all 23 decline when state aid is taken into consideration. At the same time, the situations of 7 of the 16 municipalities with column 2 indices below 100 are improved by state aid. Chicago, in particular, gains by even more than it does from federal aid—state aid boosts its index of revenue-raising ability by more than 10 points, from 87 nearly to the areawide average. The municipality with precisely average revenue-raising ability after federal aid (Oak Park) sees its index slip to 95 when state aid is considered, and Westchester drops from 108 to 95.

Again, the effects of state aid on fiscal capacity parallel those mentioned for revenue-raising ability (see column 7 and the third bars in the figure). Chicago's fiscal capacity rises from 78 to 87. Sauk Village, with the lowest fiscal capacity with and without federal aid, sees its index boosted from 42 to 54 by state aid. At the other extreme, Lake Forest's index drops from 312 to 266. These gains and losses are all relative to the areawide average. For example, the governments serving Lake Forest receive much less state aid than do those serving the average community in the metropolitan area, so Lake Forest's relative position declines significantly, though it remains far above the average.

Clearly, fiscal disparities in Chicagoland are much more complex than is implied by the naive model of central city versus suburbs that pervades the literature on urban fiscal issues.

Robert W. Rafuse, Jr. is a senior visiting fellow at ACIR.

Notes

[1] The estimates were developed by the Regional Revenue and Spending Project, a series of studies of local government finance in the Chicago area sponsored by The Regional Partnership. The results of the studies were presented at a conference in Chicago in April 1991, "Paying for Government in Chicagoland." In addition to the work discussed in this article, which was completed under a contract between the Advisory Commission on Intergovernmental Relations and The Regional Partnership, studies reviewed trends in federal and state aid to local authorities; examined recent developments in local tax, expenditure, debt, and financial management policies; and surveyed emerging problems and possible strategies.

[2] Complexity is not synonymous with decentralization. Illinois had 6,628 local governments in 1987, more than any other state. Pennsylvania, ranking second, had 4,957 units; the U.S. total was 83,237. U.S. Department of Commerce, Bureau of the Census, *1987 Census of Governments, Government Organization* (September 1988), Tables 1 and 23. Notwithstanding the multiplicity of entities, government in Illinois conforms very closely to the average for all states in the extent to which the provision of services is decentralized. Localities spend 60 cents and the state government 40 cents of each dollar of final general expenditures by Illinois' public entities. In the nation as a whole, local governments also spend 60 cents of every dollar. Florida is the most decentralized state by this criterion. Its local governments are responsible for 69 percent of direct expenditures in the state. Hawaii is the most centralized. Its four county governments account for only 23 percent of all direct state-local spending. When it comes to revenue raising, however, responsibilities are more decentralized in Illinois than in the nation as a whole. Local governments in Illinois collect 48 cents and the state 52 cents of every dollar of general revenues from Illinois sources (that is, ignoring federal grants). The comparable figure for local governments nationwide is 45 cents. All data are from U.S. Department of Commerce, Bureau of the Census, *Government Finances in 1987-1988*, (January 1990), Table 29.

[3] More specifically, tax price is the ratio of the taxes paid by a typical individual or business to a local government to the level of public services provided by that government. If it were possible to define a measure of the quantity of public services provided (it isn't), tax price would be the cost to the taxpayer per unit of that measure.

[4] For example, tax prices tend to be higher in central cities than in suburban and rural areas, reinforcing the variety of factors that tend to discourage businesses from locating in central cities. If revival of the economies of central cities were deemed an important objective of public policy—rather than facilitating such decline as market prices may suggest is most consistent with maximizing national economic efficiency—efforts to bring tax prices in cities into line with those elsewhere by such devices as enterprise zones might be appropriate.

[5] The structure of government is an essential aspect of an analysis of actual fiscal behavior. The most difficult aspect of the study of the 40 municipalities was the compilation of a uniform data base on the finances of every local government serving the municipalities. As the jurisdictions of many of the entities are not contiguous with municipal boundaries, extensive apportionment procedures were required. If the analysis were attempting to measure the fiscal capacities of local governments of a particular type—say school districts—difficult issues involving the claims of overlapping jurisdictions on a district's revenue-raising potential would have to be dealt with.

[6] The categories and the representative bases used are discussed in Robert W. Rafuse, Jr., and Laurence R. Marks, *A Comparative Analysis of Fiscal Capacity, Tax Effort, and Public Spending among Localities in the Chicago Metropolitan Region*, prepared for The Regional Partnership (ACIR, March 1991). The categories are those defined by the U.S. Bureau of the Census. Data compiled by the Bureau in the 1987 Census of Governments are used in the study.

[7] The workload measures used for the 29 categories of expenditures analyzed, the reasoning behind the choice of each, and the sources of the data used in preparing the estimate can be found in Appendix A of Rafuse and Marks. A municipality's representative expenditure for a function is its workload for the function multiplied by the areawide average spending by all local governments per unit of the workload measure.

[8] The adjusted index is calculated by adding revenues actually received from the federal government by all governments in the six-county area and by all entities serving each of the sample municipalities to the estimates of representative general revenues from own sources that are the basis for the index in column 1. Expressing the revenues on a per capita basis and indexing the result to the six-county average yields the index in column 2.

[9] As in the calculation for federal aid, actual state aid is added to the revenues (own representative plus actual federal) of the sample municipalities and to the corresponding total for all local governments in the six-county area, per capita amounts are calculated, and the results are indexed to the areawide average.

Singular Fact: The Single Audit Program Works

William C. Fanning
and John O. Behrens

If you had to pick a goal likely to inspire support among governments at all levels, you might well pick the achievement of high quality audits any time substantial public funds are disbursed. It was natural, then, that consternation followed the report in March 1984 by the General Accounting Office (GAO) that only 20 percent of cities and counties, in the states reviewed, had completed single audits in accordance with then applicable Circular A-102 and its widely known Attachment P.

As far as the Congress was concerned, the latter documents were perceived to be part of the problem. Before the Congress ordered the GAO study, large amounts of federal financial assistance were not subject to audit, and agencies occasionally overlapped in discharging their oversight functions. The GAO report lent credence to a consensus that implementing Circular A-102 was slow and difficult, in part, because federal, state, and local officials disagreed about the scope and purpose of the single audits as the circular described them.

Congress resolved the situation by passing the *Single Audit Act of 1984* (Public Law 98-102 U.S.C. 7501-7507, approved October 19, 1984), soon thereafter the source of Circular A-128. This document clarified the requirements for implementing single audits for all federal assistance programs to states and local governments.

The report of the Government Operations Committee that accompanied the law made it clear that "a single audit must include an evaluation and written report on the recipient's internal accounting and administrative control systems over its federal financial aid programs," even though the auditor need not express a formal opinion on those controls.

The act applies, with respect to any state or local government, to any fiscal year beginning after December 31, 1984. The Act says that state and local governments which receive at least $100,000 in federal financial assistance in any fiscal year need to have a single audit conducted. Additionally, each state and local government which receives between $25,000 and $100,000 in federal financial assistance in any fiscal year has the option of complying with the audit requirements of the act or with those of the federal program authorizing the assistance.

An affected government (undoubtedly relieved by this) may comply with one financial and compliance audit of all financial operations of a state or local government, or a series of audits of individual departments or other components receiving federal funds. Governments receiving federal funds of less than $25,000 are exempt from the requirements. The exemption does not, however, relieve that government from the obligation to maintain adequate records and to permit access as directed by law.

Other key provisions of the law include the following:

1) The director of the Office of Management and Budget (OMB) has designated certain federal departments as "cognizant agencies," each to ensure that the audits it is assigned to monitor are completed and delivered on time, with corrective action plans. Cognizant agencies monitor about 1,800 governments, including all states and many large counties and cities. Each cognizant agency reports to OMB the governments failing to comply, and also coordinates any additional audits done by or for federal agencies under contract, so that additional audits build on those the law requires.

2) For any fiscal year beginning after December 31, 1986, a state or local government may conduct its audits (biennially covering both years) if the state has authorized such timing in its constitution or statutes.

3) Each audit is to be conducted by an independent auditor in accordance with "generally accepted

government auditing standards," which do not necessarily require economy, efficiency, or program results audits.

4) Each audit covers operations for the entire state or local government, which may, however, limit coverage to units receiving financial assistance during the year. The audit may also exclude some public hospitals and public colleges and universities (see below).

5) Each audit encompasses all financial operations of the agency or entity, determining whether all financial statements accord with generally accepted accounting principles and applicable laws.

6) The independent auditor is responsible for selecting and testing a representative number of transactions and reporting any noncompliance.

An Intergovernmental Happening—
Federal Assistance to State or Local Recipient

Intergovernmental reality conditions the single audit program. The law specifies that the OMB director, following consultation with the comptroller general and appropriate federal, state, and local government officials, is to establish the "policies, procedures, and guidelines" to accomplish single audit tasks. The federal agencies providing the assistance are affected, as well as the recipient states and local governments (including counties, municipalities, special districts, councils of governments, Indian tribal governments, and Alaskan native villages). Public hospitals and public colleges can be included; they also can be excluded if they were audited in accordance with *Uniform Requirements for Grants to Universities, Hospitals, and Other Nonprofit Organizations* (Circular A-110).

The director of OMB reports to the Congress annually on operations of the *Single Audit Act*, naming each government or entity that is failing to comply. Monitoring by OMB includes review of regular reports from inspectors general of the federal agencies providing the assistance. Most of such assistance comes from the departments of Agriculture, Commerce, Education, Energy, Health and Human Services, Housing and Urban Development, Labor, and Transportation, and from the Environmental Protection Agency.

The President's Council on Integrity and Efficiency (PCIE) and the General Accounting Office have also reviewed the single audit program since its inception. Monitoring by the private sector has come from the American Institute of Certified Public Accountants (AICPA), which examined activities of government entities in 1987 and made 25 recommendations for improvement in its *Report on the Quality of Audits of Governmental Units.* Although most of the recommendations were implemented by 1989, sustained improvement effort continues.

Census to OMB: Facts from the Clearinghouse

Given its charge to report to the Congress on progress "on or before May 1, 1987, and annually thereafter," OMB began looking for help soon after the law became effective late in 1984. Since the job involved thousands of state and local governments, OMB turned to the Bureau of the Census. The bureau was established as a permanent agency in 1902, after existing since 1790 as a temporary unit. In addition to the decennial census of population and housing, the bureau conducts five-year censuses, and more frequently, surveys of agriculture, state and local governments, manufacturers, mineral industries, construction, and transportation.

The Census Bureau reports on all 83,237 governments in the United States. In addition to the 50 states, there are 83,186 local governments, 38,933 of them general (including 3,042 counties, 19,200 municipalities, and 16,691 townships), and the remaining 44,253 of them limited (including 14,721 independent school districts and 29,532 special districts). All of them (federal, state, local) collected a total of $1.1 trillion dollars in taxes in the year ending September 30, 1990, including $572 billion in individual and $117 billion in corporate income taxes, $154 billion in local and state property taxes, and $139 billion in sales taxes and customs. Among major federal outlays, which together exceed $1.1 trillion, federal aid in the form of grants, shared revenue, and payments in lieu of taxes to state and local governments amounted to $135 billion. This amount constitutes by far the most of what is subject to the *Single Audit Act*, although research grants may add a relatively small amount.

In practical terms, OMB asked Census to establish a "Single Audit National Clearinghouse" in December 1985, to receive, count, and classify audit reports. Census receives input from a variety of sources. Thirty-two states have established clearinghouses to assemble reports from local governments and send them to the national clearinghouse. In the other 18 states, local governments send their reports to the clearinghouse directly.

Census reported to OMB in May 1986 that about 16,000 state and local governments received the minimum ($100,000) in federal financial assistance required for coverage by the *Single Audit Act*. By April 30, 1988, the end of the first reporting cycle, Census reported that about 96 percent of the required audit reports had been received.

Since 1988, Census has refined its computer processing systems so that by 1991 the staff was able to identify 17,087 local governments, among the 21,427 submitting fiscal reports, which had received $100,000 or more in federal funds. A summary of the four reporting cycles ending with April 1991 appears in Table 1.

The number of governments failing to respond with single audit reports declined to 152 for the 1991 cycle, after increasing from 148 to 203 from 1989 to 1990. The large number of nonrespondents (695) for 1988 reflects the difficulties which attend initiation of a program of this scope. Even now, absence of a report does not necessarily mean that the government is not in compliance. Many hospitals, colleges, and universities have the choice of audits under separate guidelines. There is also a time difference between the actual date of a government's report and its emergence as Census Bureau data. Moreover, state and federal reviews of audit data may delay their processing.

Table 1

Four-Year Comparative Summary of Governments Submitting or Not Submitting Federal Financial Assistance Schedules

(years indicated)[1]

Item	Number of Governments			
	Cycle 1[2] (April 1988)	Cycle 2 (April 1989)	Cycle 3 (April 1990)	Cycle 4 (April 1991)
Governments in original contact group	NA	46,000	48,110	48,775
Local governments likely to have single audit requirements[3]	15,708	16,148	17,037	17,087
Governments submitting reports	18,337	19,770	20,851	21,427
Governments with $100,000 or more in federal revenue per Census files[4]	12,213	12,916	13,487	11,612
Governments with less than $100,000 in federal revenue per Census files[4]	6,124	6,854	7,364	9,815
Governments not submitting reports[5]	695	148	203	152
Number of governments affected	16,000	13,064	17,257	16,396
Submitting single audit reports	15,360	12,916	16,845	16,845
Response rate of reporting governments (percentage)	96.0[2]	98.9	97.6	98.3

[1] Years shown are those of the reporting cycles at the National Clearinghouse.

[2] Response rate showing proportion of affected governments submitting single audit reports is least realistic for 1988, because of data constraints associated with a new program.

[3] Local governments (respondent and nonrespondent) that had $100,000 or more in federal revenue per Census Bureau data files plus, for 1988, 1989, and 1990, an estimated 45 percent of governments below this level which submitted reports to the Clearinghouse; for 1991, a total of 4,464 governments below the $100,000 level, said number based on Census staff review of applicable schedules.

[4] For counties, cities, towns, and special districts, federal revenue refers only to amounts received directly from the federal government. For school districts it also includes federal money distributed through states.

[5] Governments which had $100,000 or more in federal revenue per Census files. Excluded from the count for 1988 and 1989 are about 800 governments which submitted a report for either the prior or subsequent year of coverage.

Encouraged Yes, Complacent No

While this article is hardly an "audit" of the single audit program, an important inference emerges about its performance and prospects—the program does work, but with no reason for anyone to be complacent. Implementing the law meant introducing a new concept to improve audit content and coverage in an intergovernmental environment peopled by state and local as well as federal officials. A "single" audit in that setting may well be a means to avoid duplication, or an eminently effective relief from "excessive inquiry," or a new departure fully compatible with "generally accepted auditing standards," or "all of the above."

As views of the cognizant agency alluded to later make evident, "single audits" are "different" in some circles. They tend to provide information about entire entities for the federal fiscal year, not necessarily specific program information for the auditee's fiscal year. Some managers still recoil from this approach, while others find substantial merit in it. It has meant more audit coverage of more federal financial assistance, in contrast with a past marked by no audits for some programs and audits limited in effectiveness, if not frequency, for others.

Results from Four Reporting Cycles, 1988 to 1991

Each annual report to the Congress speaks favorably of the many audits being completed in accordance with the law. For the 1988 cycle, four of every five audit reports were issued with only minor changes. In some, however, findings and recommendations were missing or not developed, while others lacked evaluation of internal controls and documentation for compliance testing. At one cognizant agency independent auditors did not identify unallowable cost, incorrectly included in cost allocation plans, in 15 out of 18 assistance programs.

One improvement came quickly. During the 1989 cycle OMB circulated answers, in simple terms, to the questions asked most frequently about audits by federal, state, and local government officials. Following closely was an updated compliance supplement which set forth requirements for 62 programs that accounted for over 90 percent of federal aid to state and local governments.

The 1991 report, however, noted a continued need for improvements. The President's Council on Integrity and Efficiency noted that audit reports from independent CPAs required major changes 51 percent of the time in fiscal 1988 42 percent for fiscal 1989, and 45 percent for fiscal 1990.

For the 1990 cycle, deficiencies that necessitated major changes to audits included inadequate evidentiary matter, missing reports on internal controls, missing financial statements, and confusing reporting language. Efforts to overcome deficiencies focused on reviewing reports in each subject category. This led to corrective action only for reports actually reviewed.

Concern about audit usefulness arose among inspectors general and program managers, both groups maintaining that primary responsibility for audit quality rested with state and local governments. Comment from officials of the latter governments is not available.

Similar concerns surfaced in OMB's report to the Congress for the 1991 cycle. Alluding to a six-state review of federal aid from a major federal department, OMB noted that 34 percent ($768 million) of affected expenditures "either were not audited or received very limited audit coverage." Moreover, about 70 percent ($226 million) of smaller programs of the same source received limited audit coverage. There were "numerous instances" where expenditures were inaccurate or simply not stated. Regarding the need for improvements, federal programs

naturally exude impressions based on size, and the single audit program, with many governments and many more dollars, is no exception. Its documentation, reinforced annually, can easily constitute cavalcades of gloom for fertile imaginations. Fortunately, the program has not only accomplished much but has also produced practical suggestions for improvement. As one further dividend from the AICPA Task Force studies, OMB and inspectors general share with 33 state boards of accountancy the correspondence to auditors that identifies deficiencies needing correction. Such sharing does not trigger disciplinary action but does inform the state boards. In addition, during 1990, inspectors general referred 44 certified public accountants for disciplinary action and suspended 20 of them for periods of up to three years each.

How One Cognizant Agency Views the Program

Table 2 documents, over parts of five calendar years, single audit involvement for one cabinet level department, assigned by OMB as a "cognizant agency." This is one agency's experience and reaction, not necessarily typical (no agency is "typical").

As the table indicates, the agency monitors single audit activity for 916 state and local government entities. Many have since been combined with statewide and countywide audits, so that the latest total is 726. Annual federal funding involved approximates $50 billion.

Entity response (those reporting expressed as a percentage of those required to report) stabilized at close to 80 percent annually. Disallowed costs as a percentage of questioned costs reached 67 percent in 1990 after dropping from 86 percent in 1988 to 58 percent in 1989. The relationship remains unsatisfactory to some program managers.

Quality control procedures begin with limited desk reviews of all reports. Selected entities then receive intensive quality control review. Such reviews may direct attention to amount of funding, results of desk reviews, experience in previous audits, fiscal history, missing schedules, omission of corrective recommendations or of internal control ratings, and inadequate compliance testing.

Audit vigilance obviously remains a necessity, but in perspective. This Cognizant Agency, referring 11 substandard audits to authorities for disciplinary action during the most recent reporting period, said: "In general, we have been able to secure reports that are in compliance with single audit requirements by providing technical assistance before and during the process . . . we have seen an increase in the quality. This improvement has been due, in part, to (1) training seminars for federal funding agencies and public accounting firms and (2) working closely with the funding agencies, auditees, and accounting firms, providing them with technical support."

These comments, plus some more recent ones from the same agency and others, suggest that discordant reactions born of program oriented audits are evolving into a salutary consensus favoring the single audit concept based on entity-wide reporting. By 1990, program managers and inspectors general, who had winced at the lack of "specific" information about "individual programs," agreed that most remaining problems with the single audit related to uneasiness about the concept.

During the evolution, all parties do agree that three current problems near solution: (1) difficulties of prime recipients in getting quality audits from subrecipients, (2) outdated compliance supplements, and (3) small sample sizes auditors sometimes use.

It is widely expected that Circular A-133 (*Audits of Institutions of Higher Education and Other Non-Profit Organizations*), issued in March 1990, will solve the first problem. It expands audit requirements for nonprofits and makes them consistent with those for state and local governments. Compliance requirements for larger programs are said to be due by June 30, 1991.

Regarding the second problem, OMB issued another compliance supplement in September 1990, concerning programs that provide over 90 percent of financial assistance to state and local governments.

The third problem, small sample sizes, is yielding to experience, an influence, along with trial and error and adherence to statistical principles, that portends quick recognition of representative samples.

Table 2

Single Audit Involvement of a Selected Cognizant Agency (A Federal Cabinet Department)

(fiscal years indicated)

	1987	1988	1989	1990
State and local governments assigned	916[1]	760	726	na
Required to submit an audit	na	712	670	na
Required audit reports				
Received	724	599	521	na
Not received	192	113	149	na
Percentage received	79	84[2]	78	na
Received and rejected	9	12	1	na
Quality control procedures				
Desk review	na	712	599	521
Quality control reviews	na	31	32	17
Illegal acts and irregularities	na	5	2	na
Resolution of audit findings				
Questioned costs ($millions)	28	86	92	na
Disallowed costs ($millions)	24	50	62	na

[1] Higher than numbers for subsequent years because after 1987, some entities combined with state and local governments for audit purposes.

[2] Overstated. Several entities granted extensions were counted as having reported.

Source: Annual Reports of Cognizant Agency to Office of Management and Budget.

Prospects for the Future

In a sense, the term "single" audit tells all, about the transitional period and about the bright promise of the program. The *Single Audit Act* came in the wake of more audits than seemed necessary for some programs, and no audits at all for others. With the advent of a comprehensive "single" audit built around requisite information for the entire entity being audited, in a framework of modern technology, a new day is dawning.

A very welcome, compatible part of that dawn is Circular A-133, the policy guidelines for audits of nonprofit institutions. This should help standardize the work, in precincts proximate to those covered by Circular A-128.

Finally, the single audit program has an intergovernmental advantage: There is reason (beginning with response rates) to believe that states and local governments meld with the evolving federal consensus in supporting it. Complying by doing a "single" thing has a pleasurable ring to it.

William C. Fanning is assistant division chief for operations, Government Division, U.S. Bureau of the Census. John Behrens is a visiting fellow at ACIR.

State ACIRS

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constitutional amendments, regulations, and model local ordinances; and conducting and disseminating surveys on issues of current interest.

Conclusion

State ACIRs can and should be practical and adaptable organizations. At the same time, a state ACIR ought not to lose sight of the big picture. A state ACIR has an important role to play in helping to frame issues, helping elected officials and private citizens to think about ways of understanding state-local relations, and serving as a model for effective intergovernmental processes.

Success, however, is neither inevitable nor given. Those ACIRs that have prospered and endured have worked hard at it. Those that have not may have tended to lack a permanent legislative base, a balanced membership, a work program with relevance to its constituent groups, an adequate budget, or a professional and evenhanded staff.

The first step a state can take toward having a successful ACIR is to establish one. Suggested state legislation is available from the U.S. ACIR to help with that task. Even more important, there are now many effective state ACIRs able to offer many lessons to help lead a new group to success.

Andree E. Reeves is an analyst at ACIR.

Notes

[1] U.S. Advisory Commission on Intergovernmental Relations (ACIR), *The Challenge of Local Government Reorganization*, Vol. III of *Substate Regionalism and the Federal System* (Washington, DC, 1974).

[2] _______, *State-Local Relations Organizations: The ACIR Counterparts* (Washington, DC, 1990).

[3] Ibid.

[4] _______, *Directory of State-Local Relations Organizations: The ACIR Counterparts* (Washington, DC, 1990).

[5] _______, *State-Local Relations Organizations.*

Taking Federalism Underground

(continued from page 7)

age, and inhibit transfers of rights from lower valued to higher valued uses. These problems are compounded in several states by the existence of separate systems for surface and groundwater supplies and by the unquantified federal reserved rights. Most states fail to allocate rights to storage capacity in underground basins, making users understandably reluctant to store water if they cannot be assured of access at a later time. More effective coordination of water use requires rights characterized by certainty and flexibility. Most existing systems impose obstacles to both.

Local and federal pricing practices have failed to provide incentives to use water efficiently and conservatively. In many places, water is not metered, so consumers do not incur costs in proportion to their use. In other communities, where water system revenues are not sufficiently separated from general fund or other revenues, either the water system subsidizes other functions or vice versa, disrupting the equitable distribution of costs and benefits.

Federal projects to construct, operate, and maintain water supply systems often have resulted in heavy subsidies to local users, so that they have virtually no incentives to conserve or manage supplies. In some locations, the anticipation of being "bailed out" by a federal water project works against the prospect of developing an effective coordination program.

All of these institutional barriers can be overcome. The federal government has considered several initiatives related to groundwater during the past decade. Most of these are mandates or conditions on federal assistance to state and local governments, although the scope of potential direct federal action has been expanded by the Supreme Court's holding in *Sporhase* v. *Nebraska* that groundwater is an article of interstate commerce. If federal mandates and conditions push state and local governments toward a particular statutory or organizational model of groundwater management, however, they may inhibit innovations. In particular, conditioning financial assistance for water projects on federal approval of state or local groundwater management programs may be counterproductive if projects create subsidized and underpriced water supplies.

The federal government's role in research and its investigations through the programs of the U.S. Geological Survey and other agencies have given states and localities much technical and scientific information about groundwater resources. That information has been invaluable in planning appropriate management strategies, improving existing programs, and designing new ones.

The federal government also has shown considerable deference to state laws and local water users in assigning rights and allocating resources. This has resulted in considerable innovation, although important institutional obstacles remain. As attention to groundwater supplies and to their coordinated use with surface supplies and storage continues to grow, it will be important to remove institutional obstacles to more effective coordination.

William Blomquist is an assistant professor of political science at Indiana University.

Intergovernmental Digest

Court Calls Federalism Out of Retirement to Uphold Mandatory Retirement for State Judges

On June 20, 1991, the U.S. Supreme Court issued an unusually strong federalism decision in *Gregory* v. *Ashcroft*. Contrary to an EEOC ruling, the Court held 7-2 that the Missouri Constitution's rule that state judges retire at age 70 does not violate the federal *Age Discrimination in Employment Act of 1967 (ADEA)* or the U.S. Constitution's equal protection clause. At ACIR's March 1991 meeting, the week the case was argued before the Court, Governor John Ashcroft referred to the EEOC ruling as "preemption by evolution," whereby regulatory agencies gradually expand preemptive laws through rulemaking.

The larger significance of the decision lies in Justice Sandra Day O'Connor's majority opinion, which emphasized dual sovereignty. O'Connor further noted that "the authority of the people of the states to determine the qualifications of their most important government officials... lies at the heart of representative government," and "is a power reserved to the states under the Tenth Amendment" and protected by Art. IV, Sec. 4, of the U.S. Constitution, which obligates the United States to "guarantee to every state in this Union a Republican Form of Government."

Although the Court avoided a direct "constitutional problem" by holding "that the *ADEA* does not apply to state judges," O'Connor intimated that the Court's Tenth Amendment holdings in *Garcia* v. *San Antonio Metropolitan Transit Authority* (1985) and *South Carolina* v. *Baker* (1988) are too constraining. She seemed to suggest an openness to new approaches to the Tenth Amendment and to the more recent argument that the constitutional guarantee of a republican form of government has federalism implications. However, Justices Byron White and John Paul Stevens, while concurring in the decision, vigorously dissented from O'Connor's federalism argument. They argued that "the majority's federalism concerns" were "irrelevant" to the case, and that the majority's "remarkable" reasoning contravened *Garcia* and *South Carolina*.

Justices Harry Blackman and Thurgood Marshall dissented from the decision, arguing that judges are not policymakers, whom the Congress intended to exempt from the *ADEA*, and that the Court should have deferred to EEOC's finding.

For now, then, the Court still operates on the *Garcia* principle, which holds "that states must find their protection from congressional regulation through the national political process" rather than judicial interpretation of the Tenth Amendment, and that the Court should not reverse a legislative result unless the political process was defective. The O'Connor majority, however, may be willing to carve out certain realms of judicially protected state powers—in this case, essential "political functions," such as removing state judges—and to hold the Congress to a "plain statement" rule that would allow courts to "be absolutely certain that Congress intended" to intrude on state powers. But when the Congress does make a "plain statement" of preemption, then *Garcia* will presumably oblige the Court to accept the result, unless the process that produced the preemption was defective.

Local Governments May Regulate Pesticides

Local governments scored a significant victory on June 21, when the Supreme Court ruled in *Wisconsin Public Intervenor* v. *Mortier* that the *Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA)* does not bar local governments from regulating pesticide usage. The Court overturned lower court rulings declaring that the Congress intended to occupy the field, and thus preempt all local government regulations, when it amended *FIFRA* in 1972. State authority to regulate pesticides was not at issue because the law specifically provides for state authority in this field.

New Notifications of Federalism and Small-Government Effects of Proposed Federal Regulations

Beginning with its April 1991 edition, the *Unified Agenda of Federal Regulations* has expanded its index to include special lists of proposed regulations that agencies believe may affect small governments and/or relationships among the federal, state, and local governments. The lists, which are arranged by type of effect and by agency, contain the title and sequence number of each entry. This information must be submitted to OMB by federal agencies, but has not previously been readily accessible.

Proposed regulations that have significant federalism implications are required to be identified by executive departments and agencies under Executive Order 12612 of October 26, 1987, entitled "Federalism" (3 CFR Comp., p. 252). In addition, the *Regulatory Flexibility Act* (5 U.S.C. 601) requires agencies to publish regulatory agendas identifying rules that may have a significant economic impact on a substantial number of small entities, including small government jurisdictions.

The Unified Agenda reports on regulations under development throughout the federal government. It is published in April and October by the Regulatory Information Service Center (RISC) for the Office of Information and Regulatory Affairs in the Office of Management and Budget. The most recent edition of the Unified Agenda appeared in the *Federal Register* of April 22, 1991. That edition included 59 individual regulatory agendas containing information on 4,675 regulatory actions under development in departments, agencies, and commissions that publish agendas. For further information, contact RISC at (202) 634-6220.

New Federal Laws Encourage Dispute Resolution and Negotiated Rulemaking

Two new laws signed by President Bush in November 1990 make the most substantive amendments to the *Administrative Procedures Act* since the *Freedom of Information Act of 1966*.

The *Administrative Dispute Resolution Act* (P.L. 101-552) requires each federal agency to promote dispute resolution as an alternative to litigation in the courts by (1) designating a senior official to be the agency's "Dispute Resolution Specialist"; (2) providing training for agency personnel, including those responsible for implementing the dispute resolution policy; (3) reviewing contracts, grants, and other assistance programs to ensure that dispute resolution is authorized and promoted; and (4) adopting a policy addressing potential use of dispute resolution techniques in consultation with the Administrative Conference of the United States and the Federal Mediation and Conciliation Service.

The *Negotiated Rulemaking Act* (P.L. 101-468) allows federal agencies to encourage participation by representatives of all potentially affected interests early in the process of rulemaking. The purpose is to reach consensus on the text of a proposed rule.

A-87 Review

OMB Circular A-87, concerning cost principles for state and local government assistance programs, is under review. Twenty states have provided revised language for OMB consideration concerning the use of state laws and procedures, reasonable costs, support for salaries and wages, interest costs, working capital funds, depreciation and use allowances. A revised circular is expected to be published in the *Federal Register* to allow additional comments. Federal representatives involved in consultations with state and local governments have agreed to redraft provisions dealing with pension and retiree health benefit costs, lobbying costs of appeals and claims against federal agencies, and potential conflicts with generally accepted accounting principles.

Metropolitan Organization: St. Louis and Allegheny County

Ronald J. Oakerson and Roger B. Parks

How do the many local governments in a metropolitan area organize to serve their residents? What organizational arrangements, if any, link them to one another? These are basic questions that guided our research in the complex metropolitan areas of St. Louis City and County and Allegheny County (Pittsburgh).[1] Here we compare the two areas in order to learn from the similarities and differences in their organizations of service delivery, principally in suburban areas surrounding each central city.

A widespread image of metropolitan America is expressed in a single word—fragmentation. The most common measure of fragmentation, namely, a count of jurisdictions indexed to population, says nothing about production units that do not have the status of separate jurisdictions or about interjurisdictional relationships. ACIR's goal was to understand how numerous municipalities and school districts situated in close proximity provide services and how they relate to one another.

St. Louis and Allegheny County

The St. Louis and Allegheny County metropolitan areas are similar in population size, as are their central cities (Table 1). Allegheny County has 30 percent greater land area. All of Allegheny County's citizens reside within the jurisdiction of a municipal government (there is no unincorporated territory in Pennsylvania). Twenty-eight percent of the St. Louis area citizens (40 percent of the county population) reside in unincorporated St. Louis County.

St. Louis, the central city of its area, is an independent municipality and a separate county, a result of "city-county separation" in 1876. Pittsburgh, by contrast, is located in Allegheny County. Because it is completely incorporated, Allegheny County has 40 percent more suburban municipalities than St. Louis County. The distribution of municipal size in the two areas is roughly comparable. Suburban school consolidation occurred in both areas during the 1960s and 1970s, but suburban districts in Allegheny County are more numerous and frequently smaller than those in suburban St. Louis.

Table 1
Population and Primary Government Characteristics of St. Louis City and County and Allegheny County

Characteristic	St. Louis City and County	Allegheny County
Population (1984)	1,416,508	1,409,823
Land Area (square miles)	560	730
Population of Central City (1984)	429,300	402,583
Municipal Population Outside Central City (1984)	589,996	1,007,240
Population in Unincorporated Areas (1984)	397,213	0
County Governments	2	1
Central City	1	1
Suburban Municipalities	90[a]	129
School Districts		
Central City	1	1
Suburban	23	42
Special Districts/ Municipal Authorities	≈28-29	≈143
Governmental Units	≈146	≈316

≈ means approximately.

[a] In 1985. One additional municipality, Chesterfield, incorporated after our research was completed.

Much more than in St. Louis, Allegheny municipalities and school districts have created single and multipurpose public authorities that may issue revenue bonds and provide services financed by user charges or lease-back arrangements. By conventional measures of governmental fragmentation, St. Louis and Allegheny are among the most fragmented of large metropolitan areas. As such, they offer excellent sites for studying complex systems of organization and governance.

Service Structures

Police protection, fire protection, street services, and elementary and secondary education were studied because they are common local services universally provided in metropolitan areas. For each service, we identified the local providers and producers. Providers decide whether to make a service available through public means and, if so, the quality and quantity to make available, how funding will be obtained, and the appropriate unit(s) to produce the service. Producers transform resource inputs into service outputs. In many instances, a provision unit (a municipality, county, school district or other special district) organizes an internal production unit (a police or fire department or a school system). Often, however, a provision unit arranges for production by an external organization, through contracts or other mutually agreeable arrangements.

Each study distinguishes between direct and indirect services. Direct services are supplied to citizens. Indirect services are supplied to producers and indirectly to citizens. For example, direct police services include patrol and immediate response to calls; direct fire protection includes suppression and prevention; direct street services include maintenance, cleaning, and snow removal; and direct education services include classroom instruction, counseling and guidance, and testing. Indirect services include police and fire dispatch, training and continuing education, purchasing, and other specialized service components. Like direct services, indirect services can be produced in-house or obtained from other producers.

Provision of Direct Services

Municipalities are the basic providers of direct police and residential street services in both metropolitan areas. In St. Louis, the county government provides police and residential street services in unincorporated territory, while Allegheny County direct service responsibilities are limited to police patrol of county property (including parks), and to some arterial streets and roads. In St. Louis, private subdivisions and street associations supplement municipal street services.

Both St. Louis and Allegheny County rely heavily on special fire protection agencies, but of quite different kinds. In Allegheny County, municipal governments and some 250 volunteer fire companies share responsibility. Most municipalities make a financial or in-kind contribution, but volunteers organize the fire company. Only three municipalities, including Pittsburgh, have their own fire departments, protecting roughly one-third of the county population. The remaining two-thirds are protected by volunteers. In St. Louis, provision of basic fire protection is split about evenly in terms of population served between 20 municipalities (including the City of St. Louis) and 23 fire protection districts that either overlap municipal boundaries or provide service in unincorporated areas.

Elementary and secondary education is provided principally by local school districts in both areas—with a few exceptions. In St. Louis County, a countywide special district provides special education and vocational-technical education. In Allegheny County outside Pittsburgh, these types of education are provided mostly by "jointures," which are federations of local school districts. In both areas, the state governments provide financial assistance and regulate education.

A responsible local jurisdiction does not have to produce services (direct or indirect) through a department organized in-house, and might make different arrangements for specific service components. Producing public services in metropolitan areas can be understood in industrial organization terms; that is, different industry structures emerge for different types of services.

Metropolitan Service Structures as "Industries"

Industrial organization theory provides a way of identifying and measuring the diverse structural characteristics of public service production in metropolitan areas. The structure of an industry is shaped along both horizontal and vertical dimensions. Horizontal differentiation or integration measures the number of firms that produce goods or services for a given market. If we think of a metropolitan area as a local public economy, analogous to a product market, the number of agencies producing a given service component measures the horizontal dimension of industry structure. Direct services, in this analogy, are final products. The production of final products depends on a supply of intermediate goods and services as inputs in the process. What we classify as indirect services are analogs of intermediate goods and services. The vertical structure of an industry is measured by the extent to which agencies produce the indirect services that they require in-house or obtain them in a "factor market" consisting of private firms and/or other public agencies.

By distinguishing between vertical and horizontal organization, one can compare structural characteristics of public service production across different services (different industries defined in functional terms) and across metropolitan areas (different local public economies). An industry can be relatively more "integrated" or relatively more "differentiated" either horizontally or vertically. Integration combines production activities in a single public agency, while differentiation sorts activities among separate agencies. Horizontal integration yields fewer agencies serving a given metropolitan area; horizontal differentiation creates more. Vertical integration combines the production of indirect and direct services in one or a few agencies, while vertical differentiation spreads production across many agencies.

Industry Structures in St. Louis and Allegheny County

St. Louis and Allegheny County exhibit significant horizontal differentiation in the production of direct services and significant vertical differentiation across service components. Where local service production is vertically

differentiated, it is possible to have a different degree of horizontal differentiation or integration for each component. In particular, it is possible to integrate the production of some indirect services in a small number of agencies, while maintaining a horizontally differentiated structure for production of direct services.

Police. The "police industry" structures in St. Louis and Allegheny County are vertically differentiated among service components, shown in Table 2. At the same time, police service organization exhibits (1) substantial horizontal differentiation for direct services, such as patrol and immediate response to calls, (2) significant horizontal integration in radio communications/dispatch, and (3) almost complete horizontal integration of training, crime lab, and investigation of the most serious crimes.

The differences between the two metropolitan areas' structures are easily explained—the major one being the proportion of police providers that produce basic services in-house, which is much higher in Allegheny County than in St. Louis. This results from staffing by part-time officers in small departments in Allegheny County, which is not permitted in St. Louis County where all municipalities with 400 or more residents must provide full-time police protection. Municipalities too small to employ sufficient full-time officers contract for service with a neighboring department or with the county police. In all, 24 municipalities—more than one-fourth of the total number of providers—contract for basic police service in St. Louis County. Contracting for police patrol service is much less common in Allegheny County. Eight small communities contract with neighbors; three municipalities operate a joint police department; and one is being patrolled during a period of financial distress by the Pennsylvania State Police.

Less significant differences are found in major case investigation and training. In St. Louis the most serious crimes are investigated by the St. Louis city and county police, and the Major Case Squad, organized as a cooperative arrangement among suburban municipal departments, county police, and St. Louis city police. In Allegheny County, the county police, acting as a de facto major case squad, and the Pittsburgh police conduct major crime investigations. For training, Pittsburgh and Allegheny County have separate programs. St. Louis has a joint city-county academy for entry level training.

The structural similarity of police service production in the two areas is much more interesting than the minor differences. Service components that can benefit from substantial returns to production scale are highly integrated: training, crime lab, and major case investigation. Dispatch, a service component with intermediate returns to scale, is less highly integrated, but much more integrated than patrol/response-to-calls, the component least likely to offer substantial scale economies. Even patrol is not as highly differentiated as it might be. The number of patrol producers is less than the number of municipalities, all of which are authorized to produce police services. The structures of the police service industry in both counties look very much alike, and both appear well adapted to the technical characteristics of different service components.

Table 2
Service Industry Structures—
Number of Producers of Selected Service Components

Service Component	St. Louis City and County	Allegheny County
Police Services		
Entry level training	1	2
Crime lab	2	2
Major case investigation	3	2
Communications—dispatch	30	53
Patrol and call response	66	122
(Number of producers possible)	92	131
Fire Protection		
Entry level training	2	2
Communications—dispatch	20	≈40
Fire suppression	43	≈253
Street Services		
Arterial street maintenance	3	3
Purchasing	58	70
Street sweeping	77	≈25
Residential street maintenance	77	125
Elementary and Secondary		
Purchasing	2	2
Audiovisual	2	2
Data processing	2	2
Special education	2	≈3
Vocational education	2	6
Regular instruction	24	43

≈ means approximately.

Fire Protection. This service presents a greater contrast between the two metropolitan areas (Table 2). The much greater horizontal differentiation of fire suppression in Allegheny County is due to its heavy reliance on volunteer fire companies. St. Louis County relies on municipal fire departments and fire protection districts that serve the unincorporated area and most smaller municipalities. In the valleys of Allegheny County, history and tradition seem to account for the pervasiveness of volunteer fire protection, sustained by a strong sense of community, often reinforced by ethnicity. Apparently, a reliance on volunteers changes the economics of fire service so that numerous small companies become economically feasible, while a reliance on full-time fire fighters induces greater horizontal integration, as in St. Louis County.

Vertically, however, the two fire protection structures look much like the police structures: almost complete integration of training and significant integration of dispatch relative to fire suppression. There also is some integration across the fire protection and police industries that does not show in the table. Police and fire agencies often share common dispatch centers and, in St. Louis County, now share a training academy.

Streets. Street service production is similar in structure to police and fire, at least among public agencies (Table 2). Missing from the table are numerous private producers of street-related services. A number of small municipalities and nearly all of the many private subdivisions and street associations that own streets in St. Louis County contract with private firms for routine street maintenance. Less contracting is found in Allegheny County (only one municipality contracts for routine maintenance). Five small municipalities have organized a joint street maintenance operation. Also, in Allegheny County, regional councils of governments (eight in all) produce street sweeping services for many member municipalities (and some non- members), reducing the estimated number of producers. Both counties have limited joint purchasing programs. Arterial street maintenance in both areas is produced by central city, county, and state departments.

Elementary and Secondary Education. In public education, the two metropolitan areas again exhibit similar structures (Table 2). Virtually the only major structural difference between them is the greater number of school districts in Allegheny County, which has an historical explanation. School districts in Pennsylvania were formed originally along municipal boundaries. Allegheny County is fully incorporated, and at one time each municipality had a separately organized and governed school district. A statewide consolidation process drastically reduced the number of districts in the early 1970s, but left 42 districts in the county outside Pittsburgh. In St. Louis County, by contrast, school districts were formed independently of municipal incorporation and often included all or parts of two or more municipalities as well as unincorporated territory. There, as in Allegheny County, the original number of districts has been reduced through consolidation and reorganization.

More striking, again, is the structural similarity between the two metropolitan areas. Educational service components that should exhibit returns to production scale are highly integrated. The specific institutional format varies, however. In St. Louis County, a countywide Special Education District produces special and vocational education, while the Cooperating School Districts of the Suburban St. Louis Area supplies joint purchasing, audio-visual services, and data processing. In Allegheny county, two intermediate units, one for Pittsburgh and the other for the suburban county, produce all of the auxiliary services plus, in nearly all cases, special education. Vocational education is produced by four "jointures" plus two local school districts (one of which is Pittsburgh).

Cooperation among Service Producers

Metropolitan researchers have long been aware of more or less extensive cooperation among local service producers. Cooperation often is characterized as ad hoc and sporadic, suggesting an unsystematic and unplanned adaptation to the immediate contingencies of service delivery. In contrast, we see cooperation as a routine process that occurs within the context of industry-like structures. The horizontal integration of selected service components is a step beyond cooperation. Service integration, by altering the configuration of production agencies, becomes a structural characteristic that redefines the parameters of cooperation.

The extent and type of cooperation vary with different services and service structures. Horizontal differentiation requires more coordination in the production and delivery of the same service component, while vertical differentiation requires coordination for different components. Horizontal integration requires less coordination to produce the same service, while vertical integration requires less coordination for complementary service components.

Obviously, there must be some degree of cooperation between producers of indirect and direct services where the latter are organized separately and more numerous than the former. There also is a pattern of cooperation among the structurally differentiated producers of direct services. This is true especially in police and fire protection, where mutual aid among departments boosts peak response capabilities and allows coordinated responses to common problems (e.g., criminal activity that crosses jurisdictional boundaries). Less cooperation is found among street departments. The nature of street service production—maintenance of fixed infrastructure in contrast to delivery of services to persons by responding to calls—most likely accounts for the lower levels of cooperation. Street service does not generate the peak load demands typical of police and fire protection.

Cooperation among school districts takes a somewhat different form—the organization of consortia for sharing ideas, information, and activities. The St. Louis area has a variety of such consortia, for example, the Regional Consortium for Education and Technology, which shares information and assistance connected with the utilization of computer technology for instructional applications. Allegheny County school districts have organized a variety of consortia, with varying memberships, through the Allegheny Intermediate Unit. Outside this institutional framework, two regional consortia have been organized, one of which is an association of schools, communities, and businesses designed to promote greater cooperation and to enrich teaching and learning.

Strong Structural Similarity

Despite some idiosyncratic differences, the four service types exhibit broad structural similarity in both metropolitan areas. A consistent pattern exists, consisting of nearly full horizontal integration of some indirect service components, partial integration of others, and much greater horizontal differentiation in the production of direct services. These service structures are no accident. Rather, they are created by the deliberate decisions of local officials and citizens, responding to the returns to scale for various service components. Instead of the chaos and irrationality often attributed to "crazy-quilt" patterns of local government, the service structures in both metropolitan areas fit an understandable pattern. The structures exhibit a high degree of symmetry, one that might be considered pleasing at least to an economist's eye if not to the metropolitan reformer's.

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A State Perspective on Taxing Foreign Investments in the U.S.

Marcia Sakai
and James Mak

Foreign direct investment—defined as development of a new business or the acquisition of at least 10 percent interest in a domestic company or tangible asset—increased sharply in the United States during the 1980s. As of 1987, the gross book value of property, plant, and equipment of U.S. affiliates of foreign companies was estimated at nearly $350 billion, averaging 15 percent annual growth since 1980. Foreign holdings of commercial property grew at an even faster pace—18 percent—during the same period, reaching $91 billion by 1987.[1] This rapidly rising foreign investment raises significant issues for federal, state, and local government tax policy.

One of the attractions of investing in the United States is that bilateral treaties generally provide foreign investors nondiscriminatory treatment under the law. Foreign-owned firms are subject to the same environmental, antitrust, and other regulations as are domestically owned firms. Thus, foreign investors generally compete on a "level playing field" with domestic investors. This may not be true in the case of taxation of capital gains from the sale of real estate holdings by foreign investors, who can avoid the payment of U.S. and state income taxes on resales more readily than domestic investors.

Before enactment of the *U.S. Foreign Investment in Real Property Tax Act of 1980* (FIRPTA), foreign investors could avoid the payment of U.S. capital gains tax in a number of ways unavailable to domestic investors, thereby obtaining preferential treatment. The intent of FIRPTA was to eliminate avoidance options and treat foreign and domestic real estate investors in the same manner.

Despite FIRPTA, however, the taxation of real estate capital gains by state governments remains an unresolved issue, potentially most important in states where foreign ownership of real estate is heavily concentrated. As of 1987, 21 states each had foreign holdings exceeding $1 billion.[2] Their aggregate holdings comprise 88 percent of all foreign ownership of commercial property in the United States. Three states—California, New York, and Texas—have 45 percent of all foreign-held commercial property.[3]

Federal Taxation of Foreign-Owned Real Estate Capital Gains

Persons in the United States (including resident aliens) are taxed by the federal government on their worldwide income. Nonresident aliens and foreign corporations are subject to net income tax only on income effectively connected with U.S. trade or business. In particular, the capital gains of nonresident aliens on the sale of assets, such as stocks and bonds, are exempt from U.S. income tax under the generally accepted principle of residence-based taxation of income from intangibles.

Prior to the enactment of FIRPTA, a foreign investor engaged in a U.S. trade or business could place real estate holdings into a real estate holding company, sell the holding company common stock, and escape capital gains taxation. Even if a domestic buyer purchased the stock and subsequently resold it, the basis of the capital gain was the purchase price of the stock. Hence, the capital gain realized by the foreign investor was never subject to tax. Thus, foreign real estate owners could avoid U.S. capital gains taxation by converting what otherwise would be a taxable real estate transaction into a nontaxable common stock transaction. Domestic real property investors could not similarly avoid the capital gains tax.

FIRPTA Enforcement

The Congress enacted FIRPTA in 1980 to tax nonresident aliens and foreign corporations on gains from the disposition of U.S. real property interests. FIRPTA established parity for foreign real estate investors in the tax treatment of gains from the direct sale of real estate and indirect sale through the stock of holding corporations. Enforcement of

FIRPTA has been difficult, however, because the rules require extensive reporting, with disclosure of ownership through all tiers to the ultimate beneficial owners, to identify the occurrence of taxable transactions.

The *1984 Tax Reform Act* eliminated many of the reporting provisions and required the buyer to withhold 10 percent of the gross purchase price and to remit the withholding to IRS. The withholding is simply a credit against income tax due, and exceptions may be claimed. Full compliance with FIRPTA remains problematic, however, because the elimination of many of the original reporting requirements makes it difficult for IRS to identify all taxable transactions. Thus, withholding is an improvement, but not a complete solution for the equity and compliance problems. Moreover, even with FIRPTA, a foreign investor can sell U.S. real estate, take the proceeds out of the country before being required to file a tax return, and thereby evade U.S. capital gains tax.

State Taxation of Foreign-Owned Real Estate Capital Gains

For states, the problems of tax avoidance and tax evasion on the gains from the sale of real property interests apply to foreign and nonresident (out-of-state) U.S. investors.[4] These investors usually can avoid gains taxation by realizing the gain in the form of a stock transfer rather than a real property transfer. However, even with a direct transfer, it is much more difficult to collect gains taxes due from foreigners than from out-of-state investors.

During the summer and fall of 1990, we surveyed the tax or revenue departments of the 21 states with the largest volumes of foreign real property investments to ascertain their methods of taxing gains from the disposition of those property interests. Few states have addressed this issue, and in those that have, legislation was passed very recently.

Among the jurisdictions with extensive foreign real property investments, only New York, Connecticut, and the District of Columbia have FIRPTA-like laws that treat the direct sale of real property and the sale of controlling interest in real property as identical taxable events. All three have enacted "controlling interest transfer taxes" that extend the traditional real property transfer/deed tax to include the transfer of intangibles where the underlying asset is real property. Like FIRPTA, the intent of these laws is to establish parity between the tax treatment of a direct sale and of an indirect sale of real estate held in a corporation, partnership, or trust. Unlike FIRPTA, these transfer taxes are not considered income taxes; there is insufficient nexus to impose an income tax on nonresident gains from the sale of intangibles.

The 1983 New York gains transfer tax law subjects to the tax all gains resulting from the transfer of real property interests within the state for which the selling price exceeds $1 million. Residential property is exempt. The tax applies to residents and nonresidents, and is assessed at a rate of 10 percent of the gain. This rate exceeds the maximum marginal New York State income tax rate of 7.5 percent for individuals and 9 percent for corporations, and is equal to the 10 percent tax imposed on unrelated business income. Although the gains transfer tax appears to be a traditional deed transfer tax, its high rate is more like that of an income tax.

Connecticut's controlling interest transfer tax, enacted in 1989 and revised in 1990, is not a gains tax.[5] The law imposes a tax of 1.11 percent of the actual value on the seller for the transfer of a controlling interest in a corporation, partnership, association, trust, or any other entity owning an interest in Connecticut real property whose "present and actual value" is $2,000 or more. This law was passed because the conveyance tax was deemed too easy to avoid.

The District of Columbia controlling interest tax also is not a gains tax, but was passed in 1989 to extend the coverage and application of the existing deed recordation tax to include instruments that transfer economic interests in real property. The act imposes a 2.2 percent deed recordation tax on the "fair market value" of the property.

The controlling interest transfer taxes in Connecticut and the District of Columbia are high when compared to other jurisdictions. The Advisory Commission on Intergovernmental Relations reports only three other states with traditional transfer/deed recordation taxes of 1 percent or more: Delaware (2 percent), Pennsylvania (1 percent), and Washington (1.28 percent).[6] The mean for all states is 0.35 percent; the median is 0.22 percent.

Despite the legal recognition of tax equity between transfers involving direct and indirect interest in real property, compliance problems remain. For example, while New York has had the longest experience with a tax based on the transfer of controlling interest, the state cannot be certain that it is capturing the gains tax on all taxable transactions. Collection of the tax is virtually assured when real property is directly transferred because the title transfer cannot be recorded without a tax certificate. Collection is less certain when transferring controlling interest in a corporation, partnership, or trust because there is no external mechanism, other than taxpayer compliance with the law, that signals a taxable transaction.

The Connecticut and D.C. laws do not provide automatic mechanisms that identify a taxable transfer. Connecticut requires that an information return be filed when a controlling interest has been transferred, but there is no penalty for failure to file. Fewer than 50 information returns have been filed. In D.C., as well, "virtually no money"[7] for controlling interest transfer tax liabilities was remitted in its first year.

State Taxation of Direct Real Property Sales

For most states, gains realized from the direct sale of real property are taxed solely through the income tax. However, identification of the gain is a cumbersome and difficult task. States that piggyback on the federal income tax have difficulty identifying sources of income from the federal return.

States use a variety of methods to identify taxable real estate transactions. A new Virginia law requires real estate brokers to provide to the state tax I.D. numbers, addresses, and value of sales by all nonresident sellers. Min-

nesota requires registration of sales by nonresidents, foreign or domestic. However, these states are in the minority. In most states, identification of taxable transactions requires extensive investigation and research by the tax department. Most states rely on information obtained from deed/transfer taxes to ascertain taxable gains. Some states use the federal 1099 forms. North Carolina uses field offices to monitor real estate transactions through newspapers; it also sends researchers to court houses to check title transfers. Many taxable transactions, particularly the smaller ones, are never identified.

When taxable gains are identified, states can require the filing of a nonresident income tax. If a nonresident investor does not comply, states often use collection agencies. Forty-five states are party to an agreement that permits them to file suit in the nonresident's home state as a last recourse. In the case of foreign investors, collecting delinquent taxes is virtually impossible because states do not have jurisdiction to file suit in foreign countries.

Withholding is another approach to identifying and collecting the gains taxes. Among the 21 states with the largest concentration of foreign real property investments, only California (1985, 1990) and Hawaii (1990) have adopted withholding, and Connecticut and Virginia have contemplated it. Withholding was rejected in Virginia because of opposition from the real estate industry and in Connecticut because of the perceived burden on homeowners. Vermont and South Carolina (not among the leading states in foreign real property investments) also have imposed withholding against a nonresident seller's capital gains liability.

The effect of withholding on tax collections is demonstrated most dramatically in Vermont. As recounted by the director of individual income taxation:

> In the early years, one of our examiners would plow through the box of these photocopies, and occasionally pick out a nonresident seller who they thought might owe a Vermont tax liability on a gain from the sale of real estate. The project, handled by a tax examiner with only basic clerical skills, and with no real knowledge of federal tax treatment on capital gains, was complacently churning out between $150,000 and $200,000 per year in additional assessments for the state of Vermont.
>
> As of the end of May 1990, eleven months into the real estate withholding law, the Department had received over $4.2 million, and had refunded approximately $200,000 under the early refund program, giving us a net to date of $4 million.[8]

California's 1985 withholding legislation piggybacked onto the FIRPTA withholding requirements. Foreign sellers who remit the 10 percent FIRPTA withholding on transfers of California real property interests are required to remit a California withholding equal to one-third of the FIRPTA amount. Withholding revenues amounted to $15 million in 1989. Since most foreigners do not bother to file subsequent income tax returns,[9] the amount of withholding is about equal to the amount of tax collections. In 1990, the California Assembly passed independent legislation that imposes a 3 1/3 percent withholding on the gross proceeds of direct sales of commercial property valued in excess of $100,000 when the seller is a nonresident, either foreign or out-of-state. The law is silent on indirect transfers. This law is expected to generate $52 million in withholding annually.

California's withholding law has provisions for waivers and reduced withholding rates. The tax department has wide discretion to grant waivers for such reasons as like-kind exchanges, installment sales, evidence that the taxpayer has a long history of filing California income tax returns, or when there are no income taxes due. The law also provides for reduced withholding if the seller can show that the tax liability is less than the 3 1/3 percent withholding.

Hawaii's withholding legislation requires the buyer to remit 9 percent of the gross selling price on direct transfers of real property when the seller is a nonresident. Amendments were proposed during the 1991 legislative session that would reduce the withholding rate to 5 percent, and exempt residences under $300,000 and entities registered to do business in Hawaii. The tax department has discretion to grant waivers for certain nonrecognition rules of the Internal Revenue Code, operative under Hawaii law, such as like-kind exchanges, as well as for transfers involving losses or zero gains. The department also has established procedures for early refunds.

The Vermont withholding rate is 2.5 percent of the gross proceeds. The capital gains tax rates range from 5 percent to 80 percent depending on the percentage amount of the gain and the length of time the land was held by the seller, with the lowest rate applied to gains under 100 percent and a holding period of six years or more.[10] The law allows reduced withholding and waivers at the discretion of the commissioner of the Department of Taxes. In South Carolina, withholding applies to the gains and not to the gross proceeds, and the rates correspond to the maximum marginal income tax rates for individuals (7 percent) and corporations (5 percent).

Evaluation of State Withholding Laws

In all four states, withholding applies only to the direct sale of real estate holdings. Thus, gains realized from the sale of stock in a real estate holding corporation still will not be taxed at the time of transfer. Unless the corporation ultimately disposes of the property or the corporation is liquidated—in which case the tax liability is deferred—gains realized in stock transactions will escape taxation.

As in the case of federal withholding, the California, Vermont, and South Carolina laws recognize the link between withholding and income tax liability by providing for reduced withholding based on a calculation of the gain. That is, withholding is not a tax, and the amount of withholding should approximate the tax liability. If a seller

can demonstrate that the potential income tax liability is less than the statutory withholding rates, the laws allow for reduced withholding.

Hawaii's law permits reduction in withholding only when there is a loss or zero gain. Although Hawaii permits short-year returns (that is, early filing), it is not an option available to nonresident businesses that are still engaged in a business in the state. These businesses would have to deviate from their normal fiscal year for income tax purposes. In the case of Hawaii's law, the link between the amount withheld and the tax liability is substantially weakened.

Withholding is clearly a better approach because it places resident and nonresident real property investors on a more even playing field. However, withholding does not eliminate all of the preferential tax treatment enjoyed by nonresident real property investors. Nor would evasion be eliminated by controlling interest transfer taxes similar to those levied in New York, Connecticut, and the District of Columbia because those states have not found a way to determine when indirect taxable transfers occur. There are no available data on the volume of indirect real property transfers. If the volume is small or if all property is ultimately sold, then withholding may well be the best solution to the problems of tax avoidance and evasion by nonresident investors.

Marcia Sakai is an economist with the Hawaii Public Utilities Commission. James Mak is a professor of economics and chair at the University of Hawaii at Manoa.

Notes

[1] *Survey of Current Business*, July 1989, p. 117.

[2] Ranked in order, they are California, New York, Texas, Florida, Illinois, Georgia, New Jersey, Hawaii, Massachusetts, Colorado, Pennsylvania, Ohio, Virginia, North Carolina, Arizona, Louisiana, District of Columbia, Minnesota, Maryland, Washington, and Connecticut.

[3] *Survey of Current Business*, July 1989, p. 127.

[4] Of course, some states have no income tax or capital gains tax. Among the 21 states with extensive foreign real property holdings, Texas and Washington have no income tax; Florida has no individual income tax, but does have a corporate income tax.

[5] Until 1990, capital gains realized by nonresidents in direct real estate transfers were not subject to the Connecticut capital gains tax. Effective January 1, 1990, foreigners are liable for the gains tax.

[6] U.S. Advisory Commission on Intergovernmental Relations (ACIR), *Significant Features of Fiscal Federalism, 1990*, Vol. 1 (Washington, DC, 1990), p. 127.

[7] Mark Gripentrog, Washington, DC, Department of Taxation.

[8] Robert A. Gross, Vermont Department of Taxes. Remarks at the annual meeting of the Federation of Tax Administrators, June 1990.

[9] Andrew O'Boyle, Franchise Tax Board. This may indicate that California's withholding rate is too low.

[10] ACIR, *Significant Features, 1990*, Vol. 1, p. 128.

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Conclusion

Simple counts of municipalities and special districts do not measure actual service production structures. Overlapping jurisdictions can facilitate metropolitan problem solving and assist with the integration of key support services. The St. Louis and Allegheny County metropolitan areas have developed quite similar structures for the production of police, fire protection, streets, and education services. With provision arrangements often characterized as "fragmented," both local public economies have organized production that is vertically differentiated among a variety of service components and highly integrated for producing indirect support services. The resulting service structures are reasonable, well ordered accommodations to production technologies.

Finding ordered service delivery and extensive cooperation for police, fire protection, streets, and education does not speak directly to the quality of these services, however. This research was limited by resources principally to analyses of structure and of conduct within given structures. Structure and conduct are precursors to but not guarantors of quality. The structures and cooperative conduct found in both areas were the result of conscious efforts to improve service quality within technological and cost constraints.

We were able to explore fiscal performance, looking for evidence of service cost inefficiencies related to structure. No evidence of systemic inefficiency—in the form of uncaptured returns to population scale—was found in either area. This appears to have resulted from each area creating structures that are consonant with anticipated returns to production scale.

A final caveat: while the four local services studied are important, they are not the whole picture. Further research is needed to describe and assess metropolitan organization and performance for such services as water and sewer, transportation, environmental quality, health, and welfare.

Ronald J. Oakerson is a senior scientist with the Workshop in Political Theory and Policy Analysis at Indiana University. Roger B. Parks is an associate professor with the School of Public and Environmental Affairs at Indiana University.

Note

[1] In 1986, ACIR began research on the organization and governance of metropolitan areas to address a *challenge of understanding*, contrasted with the *challenge of reform* that motivated many earlier studies of metropolitan issues. That is, ACIR wanted to learn how complex areas with many independent jurisdictions were organized and governed, not to pursue the question of how they might be reformed to fit any model. The research was based on a mode of analysis outlined in *The Organization of Local Public Economies* (1987).

The first case study of the portion of the St. Louis metropolitan area in the City and County of St. Louis was published in *Metropolitan Organization: The St. Louis Case* (1988). The case study of Allegheny County (Pittsburgh metropolitan area) will be published as *Metropolitan Organization: The Allegheny County Case*.

Private-Activity Bonds and the Volume Cap in 1990

Daphne A. Kenyon
and Dennis Zimmerman

State and local governments have been able to issue bonds with interest exempt from federal income taxation since 1913. State and local governments have long issued tax-exempt bonds to finance construction of schools, roads, and government buildings, and, since the 1960s, to provide below market-rate loans to businesses, first-time home buyers, and students. This so-called private-purpose debt (or industrial development bonds) was officially labeled private-activity debt in the *Tax Reform Act of 1986*.

The volume of private-activity bonds issued grew from approximately $6.2 billion in 1975 to $29.4 billion in 1980 and to $65.8 billion in 1984.[1] It was largely in response to the consequently higher federal revenue losses that the *Tax Reform Act of 1986* placed a number of limits on issuance of private-activity bonds, including the unified volume cap that became effective in 1988. ACIR sponsored a 50-state survey of private-activity bond issues and the volume cap for 1989[2] and 1990.

Volume Cap

The unified volume cap limits the amount of certain private-activity bonds that each state may issue each year, including bonds for mortgage revenue, student loans, small-issue industrial development (IDB), and multifamily rental housing. The most important type of private-activity bond not subject to the cap is debt issued for nonprofit organizations. Table 1 lists the types of debt subject and not subject to the unified volume cap.

The unified volume cap works as follows. Each state may issue tax-exempt private-activity bonds in an amount equal to $50 per resident, calculated using the most recent Census Bureau state population estimates. If the population results in a state being authorized to issue less than $150 million, the allocation is automatically raised to that amount. In operation, the population at which the states use the $150 million allocation is 3 million. The third column of Table 2 identifies the states with the $150 million cap.

Each state has its own methods of allocating volume cap authority among potential issuers. Many states divide

Table 1
Types of Tax-Exempt Private-Activity Bonds

Under Unified Volume Cap

Mortgage revenue
Small-issue industrial development
Student loan
Redevelopment
Nongovernmental output property
Government-owned mass commuting facilities
Water furnishing facilities
Sewage facilities
Non-government owned solid waste disposal facilities
Residential rental
Local electric or gas
Local heating or cooling
Hazardous waste
High-speed rail

Not Under Unified Volume Cap

Nonprofits (e.g., colleges, hospitals, nursing homes)
Government-owned airports
Government-owned docks & wharves
Government-owned solid waste disposal facilities
Veterans mortgage revenue

Note: Veterans mortgage revenue bonds can be issued by only five states and are subject to their own volume cap. There is a $150 million per organization limit on outstanding bonds issued on behalf of non-hospital nonprofits.

the initial allocation between state and local users. An alternative (or additional) division is often made among types of activities. Alabama, for example, initially sets aside 25 percent of its allocation for housing, 10 percent for student loans, 35 percent for small-issue industrial development bonds, and 15 percent for exempt-facility industrial development bonds. The initial allocation is rarely the final allocation, however. Issuers are usually given a deadline (somewhere between June and November) by which they must issue their bonds or risk having their allocation revert to a general pool for reallocation and potential use by another issuer.

If the entire volume cap authority cannot be used in one year, it can be carried forward for up to three years by filing the proper form with IRS, specifying the proposed use for the bond. Small-issue IDBs are not eligible for carry-forward financing. States may not borrow from expected future allocations, nor can they "sell" their unused volume cap to other states.

The volume cap was expected to have a less constraining effect on state issuance of private-activity bonds in the early years of its implementation. A higher volume cap was allowed for the transition years of 1986 and 1987—the greater of $75 per capita or $250 million—and an estimated $23.8 billion in special projects were allowed under the transition rules,[3] many of which were not subject to the volume cap. The transition rule authority generally could be carried forward through 1990; volume cap authority for 1986 could be carried through 1989 and authority for 1987 could be carried through 1990.

Questions

Because the unified volume cap has not been in effect long, not much is known about its effects.[4] One question is whether the volume cap places an effective limit on issuance of private-activity bonds, as the Congress intended. Has this limit become more constraining over time? Further, how do the effects of the cap vary among the states? What types of private-activity bonds are states issuing with their volume cap authority? Finally, given that authority to issue mortgage revenue and small-issue industrial development bonds is scheduled to expire December 31, 1991, how will these "sunsets" interact with the volume cap?[5]

Private-Activity Bonds and the Volume Cap

The volume cap would have allowed the 50 states to issue as much as $14.1 billion in private-activity bonds in 1990 ($13.6 billion excluding Illinois, for which data were unavailable). Actual issuance for the 49 states was $13.8 billion; $9.7 billion used 1990 volume cap authority, and $4.1 billion used carryforward authority from previous years. Forty-eight percent of total was used for mortgage revenue bonds (compared with 37 percent in 1989) and 14 percent for small-issue IDBs (compared with 21 percent for 1989).

As the first two columns of Table 2 indicate, the extent to which states bumped up against their volume caps in 1989 and 1990 varied considerably. Missouri used all of its cap in both years, while New Mexico, the state that is arguably the least constrained by the cap, used 12 percent in 1989 and 3 percent in 1990. Because of the difficulty of

Table 2
Type of Volume Cap and Percentage of Volume Cap Utilized

State	Percentage of Volume Cap Used in 1990	Percentage of Volume Cap Used in 1989	States with Volume Cap of $150 Million
Alabama	82%	NA	
Alaska	47	22%	X
Arizona	65	79	
Arkansas	99	85	X
California	86	100	
Colorado	94	56	
Connecticut	87	84	
Delaware	0	33	X
Florida	88	96	
Georgia	96	100	
Hawaii	17	29	X
Idaho	6	21	X
Illinois	NA	92	
Indiana	89	87	
Iowa	97	71	X
Kansas	98	86	X
Kentucky	63	64	
Louisiana	83	70	
Maine	100	25	X
Maryland	62	56	
Massachusetts	87	56	
Michigan	99	79	
Minnesota	89	100	
Mississippi	47	57	X
Missouri	100	100	
Montana	0	43	X
Nebraska	31	12	X
Nevada	64	30	X
New Hampshire	55	100	X
New Jersey	30	57	
New Mexico	3	12	X
New York	49	67	
North Carolina	54	54	
North Dakota	11	74	X
Ohio	94	100	
Oklahoma	92	100	
Oregon	73	77	X
Pennsylvania	70	35	
Rhode Island	62	6	X
South Carolina	95	84	
South Dakota	7	38	X
Tennessee	19	72	
Texas	100	98	
Utah	96	88	X
Vermont	34	35	X
Virginia	90	62	
Washington	97	62	
West Virginia	78	100	X
Wisconsin	89	83	
Wyoming	14	23	X

Note: Data for 1990 are preliminary.
NA—Not Available

allocating and issuing all of one year's authority within that calendar year, there is some ambiguity about constraints of the volume caps. Depending on the efficiency of the allocating system, states may be assumed to be constrained by the cap even if they use well under 100 percent for a given year. Assuming constraint at 80 percent use of the volume cap, 27 states were constrained in at least one year, while 23 states did not find the cap constraining in either year.[6]

On average, the least populous states (those using the $150 million) were less constrained by the volume cap than the more populous states (using the $50 per capita). The less populous states used an average of 48 percent of their volume cap authority in 1989 and 47 percent in 1990. The more populous states used an average of 77 percent of their volume cap authority in 1989 and 80 percent in 1990.

Alternatively stated, of the 14 states that used at least 80 percent of their volume cap in each year, 11 had populations of more than 3 million. Of the 13 states that used at least 80 percent of their volume cap in either 1989 or 1990, 9 had populations of more than 3 million. Of the 23 states that used less than 80 percent of their volume cap in both years, 15 had populations of less than 3 million.

The data do not indicate that the volume cap was significantly more constraining in 1990 than in 1989. The average amount of the cap used for all states in 1989 was 64 percent; for 1990, 65 percent. The carryforward data provide a similar picture of the constraint imposed by the volume cap in 1990 compared to 1989. In 1990, the states used a total of $4.1 billion in carryforward authority from prior years. They also carried forward $3.8 billion of 1990 authority. Carryforwards used were only slightly greater (6 percent) than new carryforwards taken.

It is possible that the national recession, which officially began in July 1990, reduced the issuance of private-activity bonds generally and thus made the volume cap less constraining. Small-issue IDBs fell from $3.2 billion in 1989 to $1.9 billion in 1990. Several states attributed this drop to a decline in applications due to the poor economy.[7]

There are two reasons, then, why we might expect the volume cap to become more constraining in the future. When the national economy recovers, issuance of certain types of tax-exempt bonds, such as small-issue IDBs, will probably increase. In addition, most transition rule authority and any carryforwards from the relatively generous 1987 volume cap expired in 1990. In 1991 and beyond, therefore, the desired issuance of private-activity debt subject to the volume cap could be higher, and the alternatives to the use of current-year volume-cap authority will be curtailed.[8]

Conclusions

The survey data indicate that the unified volume cap has placed an effective constraint on issuance of private-activity bonds for about half of the states. The extent to which states are constrained by the cap varies widely, although the volume cap seems to be more constraining for the more populous states.

It does not appear that the volume cap was generally more constraining in 1990 than in 1989, but this could be due to the national recession. Because of expiring carryforwards and transition rules, once the national recession is over, the volume cap may become more of an effective constraint for more states.

However, the impact of the volume cap may change dramatically if the authority to issue mortgage revenue bonds and/or small-issue industrial development bonds sunsets at the end of this year as scheduled. Both use a large portion of the current volume cap. If both types of bonds are allowed to sunset, the unified volume cap may not present an effective constraint on issuance of private-activity bonds for the foreseeable future.

Daphne Kenyon is a professor of economics at Simmons College. Dennis Zimmerman is a specialist in public finance at the Congressional Research Service, Library of Congress.

Notes

[1] Advisory Commission on Intergovernmental Relations (ACIR), *The Volume Cap for Tax-Exempt Private-Activity Bonds: State and Local Experience in 1989*, by Dennis Zimmerman (Washington, DC, 1990), p. 4.

[2] The 1989 results also are described in ACIR, *The Volume Cap for Tax-Exempt Private-Activity Bonds*, and Dennis Zimmerman, *The Private Use of Tax Exempt Bonds* (Washington, DC: The Urban Institute Press, 1991). Background tables displaying the 1990 data are available by writing to ACIR for "1990 Private Activity Bond Data Tables."

[3] Joan Pryde, "Rifle Shots, 1990: Bonds Totaling $1.9 Billion Sold before Deadline," *The Bond Buyer*, January 28, 1991.

[4] The small literature on the topic includes ACIR, *The Volume Cap for Tax-Exempt Private-Activity Bonds*, Dennis Zimmerman, *The Private Use of Tax Exempt Bonds*, and Joan Pryde, "Volume Limit Helps Small States, But Larger Ones feel Cramped," *The Bond Buyer*, June 14, 1990, "Big States Try to Stay within Volume Cap as Waiting Lists for Bond Allotments Grow," *The Bond Buyer*, June 15, 1990, "Carryforward: Saving Grace for States, or Sign that a Tighter Volume Cap is Needed?" *The Bond Buyer*, June 18, 1990, "Bond Hungry: Volume Caps Devoured by Environmental and Energy Projects," *Muniweek*, May 28, 1991.

[5] Authorization to issue mortgage revenue and small issue industrial development bonds did expire temporarily from September 30 until November 5, 1990. The sunsets on those bonds have had a history of being extended.

[6] Joan Pryde asked the states whether they found the volume cap confining. In 1989, 25 states indicated that they had no problems living within their cap; in 1990, 21 states said they had no problems living within their cap. ("Bond Hungry: Volume caps Devoured by Environmental and Energy Projects." Our preliminary analysis of the impact of state allocation rules indicates that every additional day available for reallocating unused volume cap of priority users increases the state's per capita cap usage by $0.07. For example, a state with 5 million residents and an October 1 date for reallocating unused volume cap originally set aside for priority users would reduce its unused cap by $10.5 million if the reallocation date were changed to September 1.

[7] Joan Pryde reports that Minnesota, Tennessee, Virginia, and New Hampshire attributed a drop in issuance of small-issue IDBs to the slow economy ("Bond Hungry").

[8] States do use carryforwards to substitute for use of volume cap authority allocated in the current year. Preliminary analysis indicates that every dollar per capita of 1987 volume carried forward reduced 1989 per capita volume cap utilization by $0.49. Assuming that the stock of available carryforwards in 1991 is less than that available in 1990 or 1989 (add year 1990 and drop year 1987), we would therefore expect current year cap utilization to increase in 1991.

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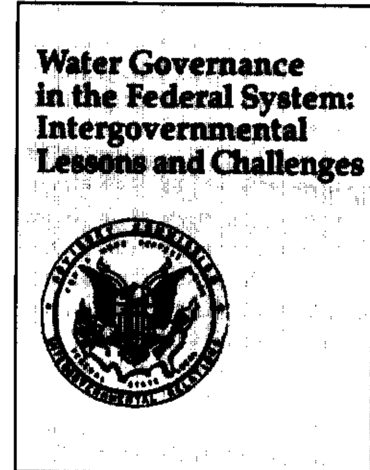

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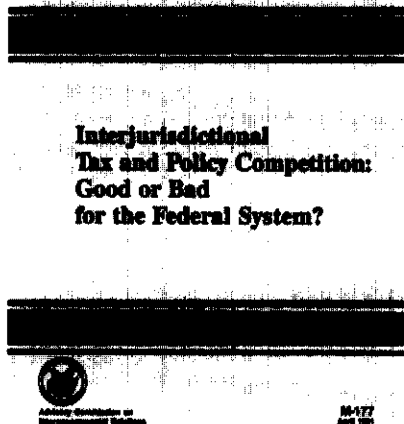


(see page 44 for order form)

Fiscal Note

The Flow of Federal Funds to and from the States

Elliott Dubin

ACIR presents data on the flow of federal expenditures to states in *Significant Features of Fiscal Federalism: Revenues and Expenditures* (Vol. 2). Occasionally, the flow of funds to states is compared to the flow of federal funds from the states. The flow of federal funds from the states is measured by the federal tax burden borne by the residents of each state.[1] The maps on pages 40-42 show the net flow of federal funds (expenditures-tax burdens), by state, for the average of fiscal years 1981-83 and 1988-90. A state with a positive balance (expenditures exceed tax burdens) is said to have a net inflow of federal funds. Conversely, where tax burdens exceed expenditures, the state is said to have a net outflow of federal funds. For the nation as a whole, we assume that expenditures are financed completely by tax revenues (i.e., there is no net inflow or outflow).

Expenditures include grants-in-aid to state and local governments, federal salaries and wages (military and civilian); direct payments to individuals (e.g., Social Security, Medicare, federal employee retirement benefits, certain veterans' benefits, supplemental security income, and food stamps); procurement contracts; and other direct payments (e.g., research and other grants to individuals and private institutions, agricultural price support payments, and health insurance premiums for federal employees). The Bureau of the Census excludes net interest on federal debt from its coverage of federal expenditures. Also excluded are the expenditures of certain intelligence and security agencies. Individual and corporate income taxes, excise taxes, estate and gift taxes, and social insurance taxes (Social Security, Medicare, unemployment insurance contributions, railroad retirement, and railroad unemployment contributions) are included in the tax burden estimates.

Maps 1 and 2 show wide variation among the states in net inflows and net outflows of federal funds. There also is wide variation in the change in the net flows between 1981-83 and 1988-90. For any given period, variations exist because expenditures in a state do not match the tax burdens of residents. Per capita tax burdens vary directly with per capita state personal income (which statistically explains about 97 percent of the variation in state per capita federal tax burdens), while federal expenditures are not directly related to personal income or tax burdens. This is due to the range and nature of federal programs.

Social Security, Medicare, and employee retirement benefits, for example, are concentrated in states with relatively large retirement populations (e.g., Florida, California, Arizona, Arkansas, and Nevada). Agricultural price support payments are concentrated in farm-dependent states. Payroll expenditures are concentrated in Washington, DC, and its Maryland and Virginia suburbs, and in other states with large regional offices, and military and civilian defense payrolls are concentrated in states with large defense installations. Grants-in-aid are distributed among the states through a variety of formulas and, in some cases such as interstate highway construction, on a project basis.

The net flow of funds by state changes over time because of changes in demographics, budget priorities, and economic circumstances. For example, as the average age of the population increases and many retirees migrate, they bring increased flows of Social Security, Medicare, and federal retirement benefits with them. Depressed farm incomes produce increases in agricultural price support payments in farm-dependent states. Changes in military priorities alter the geographic distribution of military wages and salaries, and of procurements.

Federal tax burdens will grow more rapidly than the national average in states enjoying relatively robust economic growth. Between 1981-83 and 1988-90, the percentage change in state per capita personal income statistically explained 93 percent of interstate variation in the percentage change in state per capita federal tax burdens.

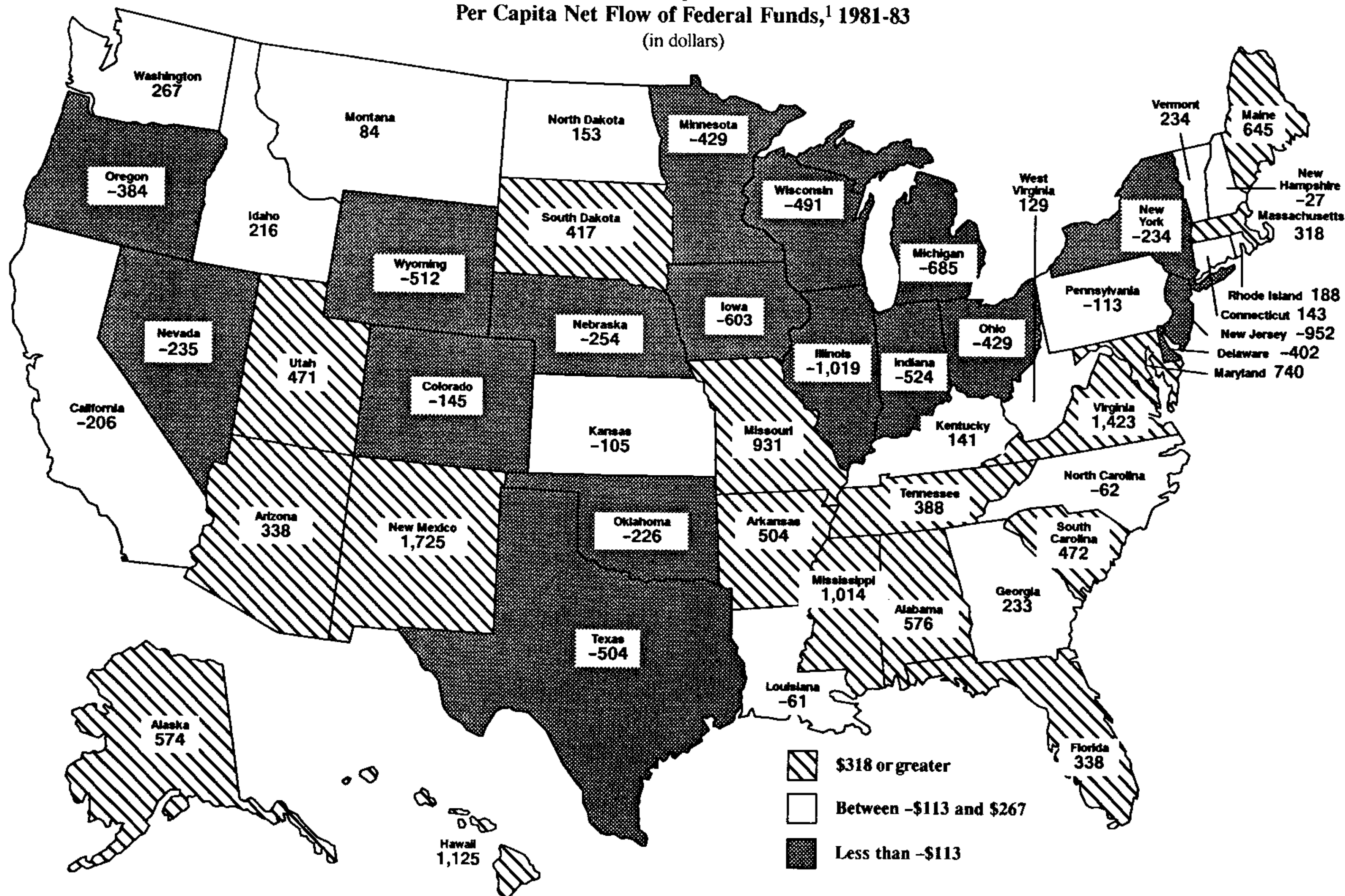
Fluctuations in the net flow of funds by state illustrate interesting demographic, economic, and policy trends, but should not be considered good or bad in and of themselves. Expenditure decisions are made with national purposes in mind, and taxes are imposed, for the most part, according to ability to pay. There is no attempt to balance expenditures and tax burdens geographically, nor is there a standard by which to judge the resulting distribution of net inflows and net outflows by state.

Map 3 shows the per capita change in each state's net flow of federal funds between 1981-83 and 1988-90, and its rank. Of the ten states with the largest change in per capita net inflows of federal funds, four are in the Plains (Iowa, Nebraska, North Dakota, and South Dakota), four are in the Rockies (Colorado, Idaho, Montana, and Wyoming), and two are in the Southwest (New Mexico and Oklahoma). Weaknesses in agriculture and mineral extraction resulted in below average growth in income and per capita federal tax burdens in all of these states, which also experienced above average growth in per capita fed-eral expenditures. In the Plains states and Montana, the growth in expenditures was fueled mainly by agricultural price supports. In New Mexico, Colorado, and Idaho, above average

Map 1

Per Capita Net Flow of Federal Funds,[1] 1981-83

(in dollars)



Note: Because of its unique nature, the District of Columbia should not be compared to the states and is not included here.

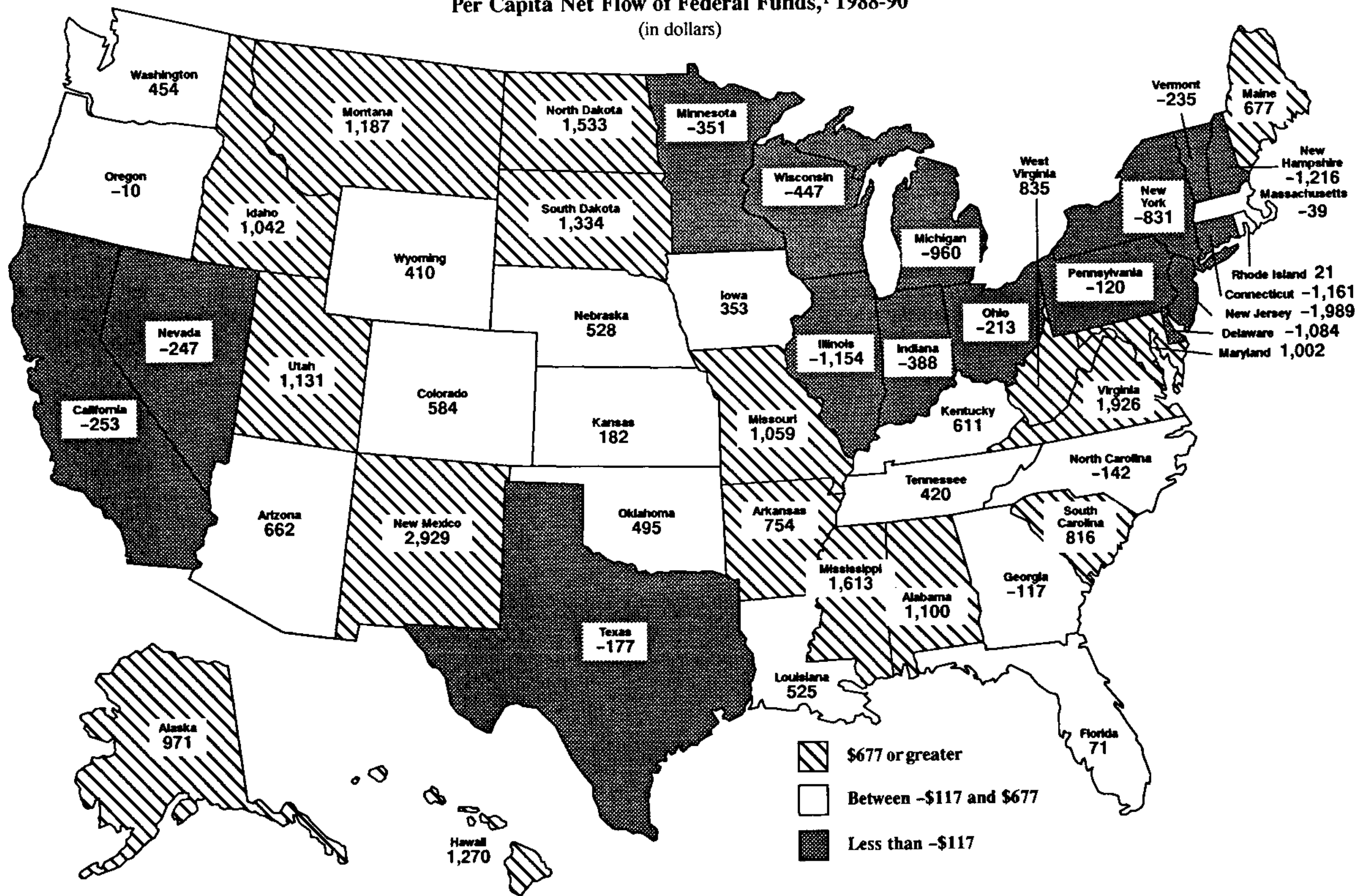
[1]Federal expenditure minus federal tax burden.

Source: ACIR computations based on data from the U.S. Department of Commerce, Bureau of the Census, *Federal Expenditures by State for Fiscal Year 1990*, Table 11; and Tax Foundation, "Federal Tax Burden by State," May 1990, and *Facts and Figures on Government Finance*, 1991 Edition, p. 146.

Map 2

Per Capita Net Flow of Federal Funds,[1] 1988-90

(in dollars)



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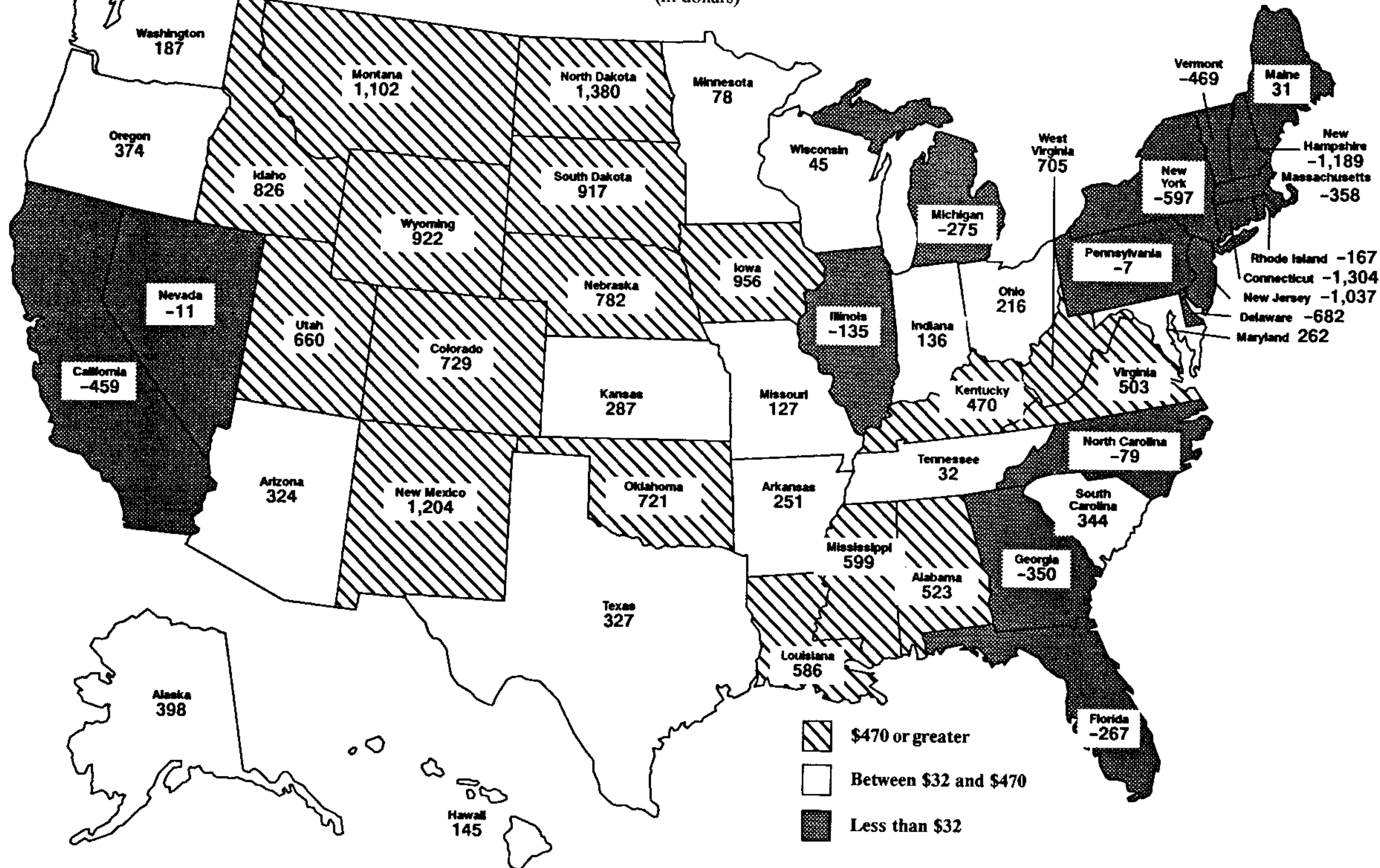
[1]Federal expenditure minus federal tax burden.

Source: ACIR computations based on data from the U.S. Department of Commerce, Bureau of the Census, *Federal Expenditures by State for Fiscal Year 1990,* Table 11; and Tax Foundation, "Federal Tax Burden by State," May 1990, and *Facts and Figures on Government Finance,* 1991 Edition, p. 146.

Map 3

Change in Per Capita Net Flow of Federal Funds,[1] 1981-83 to 1988-90

(in dollars)



Note: Because of its unique nature, the District of Columbia should not be compared to the states and is not included here.

[1]Federal expenditure minus federal tax burden.

Source: ACIR computations based on data from the U.S. Department of Commerce, Bureau of the Census, *Federal Expenditures by State for Fiscal Year 1990,* Table 11; and Tax Foundation, "Federal Tax Burden by State," May 1990, and *Facts and Figures on Government Finance,* 1991 Edition, p. 146.

growth in procurement contracts and direct payments to individuals (mainly retirement and Medicare benefits) were the primary cause of high expenditure growth. Above average increases in direct payments to individuals were responsible for above average growth in federal spending in Wyoming, where per capita procurement contracts fell by 44 percent. Rapid growth in farm assistance and grants to state and local governments resulted in above average spending growth in Oklahoma.

Of the ten states with the largest change in per capita net outflows of federal funds, four are in New England (Connecticut, Massachusetts, New Hampshire, and Vermont), three are in the Mideast (Delaware, New Jersey, and New York), two are in the Southeast (Florida and Georgia), and one is in the Far West (California). Except for California, all of these states had above average increases in per capita federal tax burdens resulting from relatively robust economic growth.

The 36.3 percent growth in per capita federal tax burdens in California was about equal to the national average (37.6 percent). In Massachusetts and New Jersey, per capita growth in federal expenditures exceeded the national average because of rapid growth in federal wages and salaries and procurement contracts. In New York, per capita expenditure growth matched the national average as above average increases in grants to state and local governments and in wages and salaries were offset by a small decline in procurement contracts. The per capita growth in expenditures for the other states in this group lagged the national average growth primarily because of declines in procurement contracts.

Elliott Dubin is an analyst in Government Finance Research at ACIR.

Note

[1] "Tax burden" refers to the ultimate incidence of a tax rather than the location of where the tax is collected. This distinction is important because it is assumed, for example, that business firms shift taxes forward to consumers in the form of higher prices and/or backward to the owners of the factors of production (labor, land, and capital). For example, federal excise taxes imposed on manufacturers of distilled spirits and tobacco products are mainly collected in a few southeastern states. It is generally assumed that the burden of these taxes is passed forward to the ultimate consumers throughout the United States.

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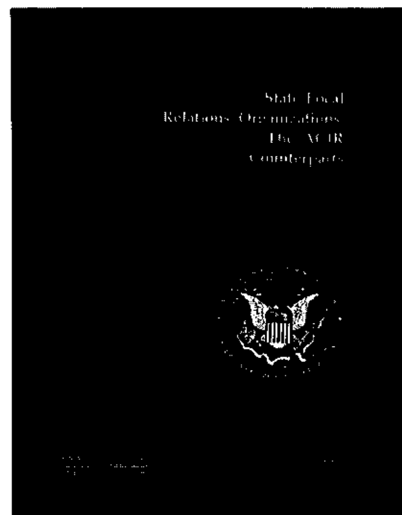

This policy report presents the results of ACIR's latest survey of the 26 operating state-local relations organizations. The Commission renews its call for each state to create and sustain an ACIR, and recommends that the national associations representing state and local governments encourage their constituents to support the ACIR concept. The report contains suggested state legislation that can be used as the basis for establishing an ACIR, and a directory including the organization, functions, staff, budgets, and work programs of the state ACIRs, as well as information about the Advisory Commission on Intergovernmental Relations and the federal departmental intergovernmental affairs offices.

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The Volume Cap on Tax-Exempt Private-Activity Bonds: State and Local Experience in 1989

The unified volume cap was adopted as part of the *Tax Reform Act of 1986* and set a limitation for each state equal to the greater of $50 per capita or $150 million, effective in 1988. Despite the significance of the legislation, little is known about the states' operations under the cap. The states were surveyed to determine the priorities they use to allocate private-activity bonds between state and local governments, the volume and composition of the bond allocations, and suggestions for reform of the volume cap rules.

M-171 1990 40 pages **$7.50**

(see page 44 for order form)

Annexation

The Future of Municipal Annexation in South Carolina. By Andrew E. Smith. South Carolina Advisory Commission on Intergovernmental Relations, 1333 Main Street, Suite 220, Columbia, SC, 29211, 1991.

This report examines annexation as a viable growth tool for South Carolina's 270 municipalities. According to the report, the state's annexation laws are the most restrictive in the nation. The research focuses on South Carolina policies; approaches in other states; and recommendations for strong, workable annexation laws that would grant local officials authority to monitor growth and development.

Courts

Current Need for and Status of Pretrial Intervention Procedures in Florida Criminal Courts. ACIR Interim Report. Florida Advisory Council on Intergovernmental Relations, House Office Building, Tallahassee, FL 32399-1300, 1991.

Florida's local jails have been subject to unprecedented increases in inmate populations in recent years, resulting in serious questions concerning the continued ability of county governments to fund construction and operation out of current revenue sources. There is a critical need for policies and procedures that permit more efficient use of jail space. In Florida, and other states, the alternatives range from diversion of new arrestees from jail by law enforcement to early screening and review by prosecution and defense counsel to procedures designed to reduce delays in processing cases by the criminal courts. Based on a survey of court and county officials, this report focuses on their perspectives on alternatives, and the implementation status of each.

Federalism

Roots of the Republic: American Founding Documents Interpreted. Edited by Stephen L. Schechter. Madison House, Box 3100, Madison, WI 53704, 1990.

This book presents the original texts of 19 early American historical documents, including the Mayflower Compact (1620); Fundamental Orders of Connecticut (1639); New York Charter of Liberties (1683, 1691); Albany Plan of Union (1754); Declaration of Independence (1776); the first constitutions of Massachusetts, New York, and Virginia, and the Articles of Confederation (1781); Northwest Ordinance (1787); U.S. Constitution (1787); essays from *The Federalist* (1787-88); and the U.S. Bill of Rights (1789). Each text is accompanied by and interpretive essay written by a contemporary scholar. Intended to help readers learn how to read and understand these documents, the book is also a handy reference and a good introduction to the development of political thought and the debates surrounding the formation of the state governments and the federal union.

Finance

Federal Funds to State Agencies. Annual Report to the Illinois General Assembly. Illinois Commission on Intergovernmental Cooperation, 707 Stratton Building, Springfield, IL 62706, 1991.

This report was designed to provide legislators and staff with a comprehensive reference guide to information on federal funds received by state agencies. With cooperation from the Bureau of the Budget, the commission records and tracks applications for and awards of federal grants. The commission also conducts an annual survey to identify receipt of aid funds. Program descriptions include objectives and services provided or supported, formulas, matching requirements, account ID numbers, and discussion of proposed changes in grants if applicable.

Federal Support for Education: Fiscal Years 1980 to 1990. Survey Report. National Center for Education Statistics, U.S. Department of Education, 555 New Jersey Avenue, NW, Washington, DC 20208, 1991.

This report provides a picture of total federal financial support for education in fiscal years 1980-1990, including programs having significant educational components but that have additional purposes as well. In the report, federal support is divided into three categories—on-budget, nonfederal funds generated by federal programs, and federal tax expenditures. Outlays rather than obligations were used in the report where possible, and the report shows current and constant dollar comparisons based on the composite deflator from the *Budget of the United States Government, Fiscal Year 1991.*

General State Aid to Schools: Circulation and Distribution of School Aid. Legislators' Handbook. Illinois Commission on Intergovernmental Cooperation, 707 Stratton Building, Springfield, IL 62706, 1991.

General state aid to elementary and secondary schools in Illinois is based on a guaranteed foundation—a minimum that the state promises will be available for the education of each student. The aid is distributed to school districts according to a formula that includes attendance, tax base, and tax effort. There are wide variations in all three factors throughout the state. The report includes sections on the components of general state aid and on the development and calculations of the formulas.

Intergovernmental Relations

The Interlocal Contract in Texas. By David Tees, Richard L. Cole, and Jay G. Stanford. Institute of Urban Studies, University of Texas, P.O. Box 19588, Arlington, TX 76019-0588, 1990.

This book is intended as a reference manual for local governments. It provides practical suggestions and examples, and aims at stimulating more jurisdictions to investigate using or expanding local contracts. Based on the results of a statewide survey, the book documents the nature and extent of contracting among cities, counties, and regional councils, with details on 25 common public services. There are

chapters on contract negotiation, preparation, and management and review. The text of the Texas Interlocal Cooperation Act is included, along with opinions of the state attorney general, and a summary of laws authorizing the performance of specific functions and services.

REGIONAL COUNCILS OF GOVERNMENTS IN SOUTH CAROLINA 1991. South Carolina Advisory Commission on Intergovernmental Relations, 1333 Main Street, Suite 220, Columbia, SC 29211, 1991.

This report is a directory of the ten regional councils in South Carolina—voluntary associations of local governments that provide a variety of services, including grant administration, economic development assistance, planning, and governmental management assistance. The councils provide a method for intergovernmental coordination and cooperation. Each council profile includes information on organization, membership, budgets, major functions, specific programs and services, and publications.

Preemption

THE LAW OF PREEMPTION. A REPORT OF THE APPELLATE JUDGES CONFERENCE OF THE AMERICAN BAR ASSOCIATION. American Bar Association, 750 North Lake Shore Drive, Chicago, Illinois, 60611. 1991.

Seeking to synthesize and analyze in-depth the law concerning federal preemption of state government powers, a task force of the Appellate Judges Conference prepared this report. It provides an historic overview of the Supremacy Clause and reviews the Supreme Court's early preemption cases. The study also examines modern preemption doctrine, particularly the implied preemption analysis of the Court. Finally, the task force identifies in recent Court cases the "emergence of a more rigorous clear statement approach to preemption, which calls upon Congress to express more explicitly its intent to displace state law." Citing the increased institutional capacity of Congress and federalism concerns, among other reasons, the task force states that greater emphasis on the requirement of clear intent would "reinforce our republican system and 'our federalism' as the nation enters its third century."

Privatization

PRIVATIZATION AND ITS ALTERNATIVES. Edited by William T. Gormley, Jr. La Follette Policy Series. University of Wisconsin Press, 114 North Murray Street, Madison, WI 53715-1199, 1991.

In this book, the result of a 1987 conference sponsored by the La Follette Institute of Public Affairs, scholars from several social science disciplines evaluate privatization efforts in the United States and abroad, and in the federal, state, and local governments. The authors look primarily at education, housing, and law enforcement, policy areas that sharply illustrate the dilemmas faced by policymakers as the debate about privatization shifts from "hard" services to human services. Consideration of alternative forms of service delivery is a major emphasis of the book.

Public Authorities

PUBLIC AUTHORITIES: ORGANIZATION, GOVERNANCE, ADMINISTRATION. Department of Public Administration, Baruch College of the City University of New York, 17 Lexington Avenue, New York, NY 10010, 1991.

This report is based on survey responses from the executive directors of 1,243 state and local public authorities (a total of 6,352 authorities was identified, but 2,055 were surveyed). These authorities perform many public services, from operating hospitals and ports to financing gas pipelines and economic development to overseeing the budgets of major cities. Public authorities are defined here as separate entities chartered either by the national government, state governments, or subunits thereof, governed by an appointed board, and responsible for public service functions. The authorities were classified according to ten major policies: economic development, education, environmental protection, health, housing, ports, public use facilities, transportation, public utilities, and multipurpose authorities.

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