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GENERAL REVENUE SHARING AND TAX REFORM CHANGES: IMPLICATIONS FOR STATE AND LOCAL GOVERNMENTS

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The elimination, in October, 1986, of the General Revenue Sharing (GRS) program; declining agricultural land values in the North Central and Plains states; and the 1986 Federal Tax Reform Act have created an environment of uncertainty and fiscal stress for state and local governments. Declining revenues and tax policy changes have the potential to alter the structure, conduct and performance of state and local governments.

General Revenue Sharing

In the first week of October, 1986, the U.S. Treasury made the final GRS entitlement payment to 39,000 cities, villages, towns, counties, townships and other communities. With these checks, General Revenue Sharing (GRS) came to an end, fourteen years and $85 billion after it was signed into law by President Nixon in 1972.

The State and Local Fiscal Assistance Act was initially authorized for a five-year period as a means of sharing federal funds with state and local units of government. Funds were restricted to operation and maintenance within eight priority categories and for any capital expenditure authorized by law. The priority categories were eliminated in the 1976 reauthorization, and recipient governments were permitted to use the funds for any legal purpose under state and local law (U.S. Department of Treasury 1981, pp. 1–5). Funding for the program was reduced with the 1980 reauthorization and state government participation was eliminated. The 1983 reauthorization reduced the total amount of GRS funds allocated to local governments and Gramm-Rudman-Hollings shrunk the appropriated amount even further. Despite the decline in the purchasing power of GRS monies over the fourteen-year period, local communities became addicted to the flow of funds for the support of local services and to balance stressed budgets.

Reliance on GRS Funds

The fiscal impact on local units of government is a function of how they used the GRS funds. Data collected by the Office of Revenue Sharing (U.S. Department of Treasury 1983) indicated that "current expenditures" accounted for 74.7 percent of the GRS funds, "capital outlays" 23.9 percent and "redemption of debt" 1.4 percent.

The results of a study by Yount (pp. 7–29) of Michigan municipalities and their uses of GRS funds paralleled the Office of Revenue Sharing study. Yount found that Michigan cities and villages spent more than 60 percent of their GRS funds on operating expenditures and 40 percent on capital expenditures. When comparing GRS fund expenditures as a percent of total municipal expenditures, the Michigan study found that the percentages ranged from a low of 0.5 percent to a high of 23.5 percent, with the median being 2.60 percent. The study further concluded that as municipalities increased in size, greater use was made of GRS funds for operating purposes which is not surprising considering the percentage of municipal budgets allocated for wages and salaries.

County governments were not immune from their dependence on GRS funds. In Michigan, federal revenue sharing dollars constituted from 6 percent to 10 percent of total county general fund revenue. If GRS dollars are converted to millage equivalents, that is equating GRS funds in terms of property tax millage, GRS funds allocated to Michigan counties in FY 1986 represented 0.57 mills. Or, stated differently, an additional 0.57 mills would need to be levied by Michigan counties to replace the lost GRS funds (Harvey 1986). Millage equivalents ranged from a low of 0.23 mills for a highly urbanized county to a high of 1.7 mills in a rural county. The $173 million loss in GRS funds for FY 1986 to all Michigan municipalities is equivalent to a 1.6 mill levy on the real and personal property tax base of the state. (Michigan real and personal property is equalized at 50 percent of true cash value for property taxation purposes).

Michigan's per capita loss ranged from $10.92 to $29.95 and averaged $19.12. Due to the weighted formula used in the distribution of GRS funds, units with a high taxing effort but with relative low tax base wealth received more dollars compared to units with a lower taxing effort and higher wealth. Thus the elimination of the program had a larger negative impact on the fiscal condition of a unit that was least able to replace the lost funds.

An often overlooked dimension to the GRS program was the subtle substitution of GRS monies for local tax dollars that occurred as local units of government designated larger and larger shares of each GRS entitlement for operating purposes. Since the property tax remains the primary revenue source for local units of government, especially nonmetro areas, the elimination of the GRS program is forcing local decision makers to reassess the services the entitlement program

was funding. Counties and municipalities that rolled GRS dollars into general fund accounts suddenly experienced difficulty in identifying services purchased by GRS monies. Units that expended GRS dollars for capital projects or designated the monies for specific services such as police, fire, senior citizen programs or computer services were in a position to articulate funding shortages to citizens, an important exercise if local units were to ask voters to replace lost GRS dollars with local taxes.

It can be argued that one of the positive outgrowths of GRS elimination is the forced realization by local decision makers and citizens of the cost of providing public services. The subsidization of local service costs through the employment of GRS funds masked the true cost of provision. A policy issue local officials often failed to ask themselves when attempting to budget GRS dollars is, "Would voters approve the necessary property tax millage or income tax increase to fund the service(s) that GRS dollars were funding?" The discontinuance of the GRS program forced reevaluation and brought the policy question to the forefront.

Declining Agricultural Land Values

While providing a financial shock to local government units, the loss of general revenue sharing represented a manageable fiscal condition for most of them. However, coinciding with the GRS program loss was the declining agricultural land value problem in the heavily dependent agriculture states. While much has been written about the precipitous decline in agricultural land values in the North Central and Plains states, it is difficult to generalize about its impact on the fiscal condition of rural local governments due to the wide variation in institutional and organizational factors that exist among states and regions in relation to their revenue and spending systems.

The most vulnerable local governments are heavily dependent on property taxes, are located where farm real estate is a major component of the tax base, have annual reassessment and operate under statutorily imposed rate limits (Chicoine, pp. 7–10).

Government units that do not reassess land on an annual or biannual basis are able to moderate the property tax revenue loss or gain since assessments lag agricultural land market values both on the upswing as well as on the decline. States requiring annual reassessment of property experience more sudden fiscal shocks when land values drop sharply. During the 1970s, when property assessments lagged market values, taxpayers seldom complained that assessments and market values differed. Institutional factors and the administration of the property tax assessment system have a significant bearing on the fiscal impact of declining agricultural land values.

The 1984 U.S. average for property tax as a percent of own source revenues for local government units was 47.1 percent (Lawson, pp. 18–21). Lawson sought to develop indicators of fiscal stress for state and local governments by examining farm dependent counties in ten states. Seven counties in Lawson's sample were located in the North Central Region and Plains and three were located in the southern United States. The dependency of the seven Plains and North Central states on the property tax as a revenue source exceeded the national average. When comparing "own source revenue growth" for the period 1982–84 with a revenue growth rate of 16 percent or less serving as the threshold for fiscal stress, five of the seven experienced fiscal stress. Based on this same threshold, the three southern states, all of which had a less-than-the-national-average dependency on property taxes, did not experience fiscal stress.

In Michigan, seventy of eighty-three counties experienced a decline in agriculture state equalized values between 1985–87, but in only fifteen counties was the decline of a magnitude that resulted in an overall decline in the total state equalized value for the counties and thus less property taxes (Harvey et al. 1987, pp. 7–8).

Michigan's worst case scenario resulted in one county experiencing a 16 percent net revenue loss through the combined effect of declining agricultural land values and GRS elimination. K–12 school systems located in agricultural dependent areas perhaps suffered the severest impact from declining agricultural land values. Some Michigan districts, for example, because of their relatively high state equalized value (SEV) per student or relatively high district property wealth, received little or no state aid prior to the rapid decline in agricultural land values due to the operation of the statutory state aid formula. While the districts' SEV per student dropped after the agricultural SEV decline, the drop was not large enough to bring the districts back into the state aid formula, but the districts experienced a substantial reduction in property tax revenue, forcing them to request additional millage to replace the lost revenue. The growth rate in other classes of real property, on the other hand, can have a tempering effect on the loss associated with the agricultural class of property.

Perhaps more significant to local government units and for states is the revenue loss associated with decline in agribusinesses and farms as a result of the financial conditions in selected agricultural sectors. Doeksen and Wood (pp. 2–10) developed a simulation model to illustrate the linkage between agriculture and rural communities. The researchers selected a rural agricultural community in north central Oklahoma with a population of 4,700 and a county population of 39,000. The model attempted to measure the impact on selected community services resulting from a 20 percent decline in the number of farm proprietors in the community. Their model produced a $28,000 decline in revenue for sewer and water services by the year 1990.

While the authors point out that the numbers may appear small, the aggregate effect (when all community services are accounted for coupled with reductions in sales, income and other taxes) would produce fiscal stress for the community.

1986 Tax Reform Act

The controversial Federal Tax Reform Act of 1986, while introducing uncertainty for individual taxpayers and businesses, has resulted in adjustments and tax changes for state governments. Since states that levy a personal income tax generally use the federal adjusted gross income as a base for state income tax calculation, the adjustments brought about by the Tax Reform Act—such as eliminating certain deductions and credits and broadening the tax base for individuals and corporations—essentially broaden the state tax base. Initial estimates concluded that the Tax Reform Act would net states $6.3 billion additional revenue. Thirty-one states would have a net gain and nine states would have lower taxes (*Lansing State Journal* 1987a).

Thus far, fifteen states have voted to keep the so-called "windfall"; thirteen will avoid the windfall by rolling back state taxes or rebating the additional revenue to taxpayers; and five will keep a portion of the net gain. Final action is still pending in California, Massachusetts, North Carolina and Michigan. Policy action by state legislatures will reduce the $6.3 billion net revenue gain to $1.2 billion and the amount would be reduced even further if the four states listed as "pending" take action to avoid collecting additional taxes as a result of federal tax reform.

In Michigan, the debate in the legislature is not only over whether to keep the windfall or to roll back taxes, but over the actual amount of the windfall. The windfall was originally estimated to yield $153 million, but the figure has been scaled down as unemployment in the state has begun to creep upward and personal income tax collections have dropped below FY 1987 projections.

Another feature of the 1986 Tax Reform Act that will impact the fiscal structure of state and local governments is the treatment of bonds issued by those units. Interest earned on bonds issued by state and local governments has traditionally been tax exempt. A vast majority of the bonds issued by state and local governments were used to finance public infrastructure development. Beginning in the 1970s, state and local governments began issuing tax exempt bonds for non-traditional purposes such as housing developments, industrial development, pollution control facilities, hospitals and student loans. As the volume of tax exempt bonds issued by state and local governments increased, so did the revenue foregone by the federal government from the tax exemptions. By excluding interest on all state and local bonds, federal income tax receipts were reduced by $18.5 billion

in 1983, according to estimates by the Joint Committee on Taxation of the U.S. Congress (Olson and Khouri, pp. 16–19).

The Tax Reform Act continues the trend of restricting the ability of state and local governments to issue tax exempt bonds. The act imposes stringent limits on the use of bond proceeds, restricts the volume of new bonds and demands that issuers of tax exempt bonds comply with more stringent reporting requirements. The act defines bonds issued by state and local governments in two major categories. The term "governmental bond" is issued to describe traditional purpose bonds issued for such activities as highway construction and financing public buildings. The term "private activity bond" is used to describe nontraditional purpose bonds such as industrial development, student loan and mortgage revenue bonds.

The Tax Reform Act, by establishing caps and defining two categories of bonds, has the potential to limit the volume of bonds issued by state and local governments. The potential also exists for prohibiting funding by tax exempt bonds of some state and local government activities. This could raise the cost of borrowing to finance such activities.

An additional feature of the Tax Reform Act is the limitation placed on the arbitrage earnings state and local governments can collect on tax exempt bonds. Arbitrage earnings are the interest earned by state and local governments from investing a portion of bond proceeds between the time the bonds are issued and the time the proceeds are needed to finance a project. The act extends the arbitrage provisions, which previously applied to Industrial Development Bonds, to all tax exempt bonds including governmental bonds. The arbitrage provision of the Tax Reform Act will reduce interest earnings to state and local governments since arbitrage was a functional finance management tool for municipal, county and state treasurers.

Response by State and Local Governments to Declining Revenues

State and local government response to a declining property tax base, the elimination of General Revenue Sharing and the Tax Reform Act has been varied. Seven states have raised gasoline or transportation taxes: Connecticut, Maryland, Mississippi, Missouri, Montana, New Mexico and South Carolina (*Lansing State Journal* 1987b). Nevada and Ohio legislative bodies are currently debating gasoline tax increases. Montana and North Dakota have imposed income tax surcharges and Indiana has raised rates.

State taxes are going down in Rhode Island, Vermont and Colorado. West Virginia is considering an income tax increase for taxpayers in the $25,000 to $40,000 bracket and cutting the tax rate for taxpayers whose income exceeds $60,000. Several states are still grappling with their budgets and tax changes. Arizona is considering a tax