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The Public Works Employment Act of 1976 requires GAO to report to Congress on the impact of Title II payments on the operations of State and local governments and on the national economy. The program is designed to achieve three objectives: maintenance of public employment, maintenance of public service, and countering the recession. It is believed that the cyclical problems brought about by recession and inflation are separate from those associated with regions and governmental units experiencing long-term economic decline. It is, therefore, not efficient to attempt to address both sets of problems with one allocation formula based on a single measure of need. The fact that a jurisdiction may face either cyclical or secular problems (or both) raises questions as to whether the present formula in Title II effectively responds to these problems. Based on preliminary observations, the current program does not provide assistance directly into the economy or provide selectively targeted assistance. Anti-recession funds are not getting into the economy quickly. This slowness is partly because governments could not plan in advance on receiving a specific amount and partly because of complicated budgetary processes. (RRS)

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of the
House of Representatives' Committee on Government Operations

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Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify before your Subcommittee concerning on-going GAO work under Title II of the Public Works Employment Act of 1976 (P.L. 94-369).

That law requires GAO, on or before July 22, 1977, to report to the Congress on the impact of payments under this title on the operations of State and local governments and on the national economy. The report is to include an evaluation of the macroeconomic effect of the program established under this title and any recommendations for improving the effectiveness of similar programs. We would like today to discuss the direction of our work and the progress that we have made to date in these efforts. I would like to emphasize that what we say today should be considered tentative, since we have not yet completed gathering data and we have therefore done only preliminary analysis.

I would like to begin by pointing out that there are two important but separate sets of economic problems that can adversely affect State and local jurisdictions. One is the set of budgetary problems that these governments face over the course of the business cycle or because of relatively short-term fluctuations in economic activity. The other is the secular or prolonged decline of an area involving, for example, major movements of people and business activity from central cities to the suburbs and from one geographical area to another. These problems are fundamentally different and may warrant markedly differing policy responses.

The Nature of the Cyclical Problem

There is a perception that layoffs, expenditure cuts, and tax increases by State and local governments in response to their fiscal problems brought about by recession and inflation tend to work at cross purposes with Federal economic stabilization programs. This view, that the actions of State and local governments have been amplifying rather than dampening the business cycle, revives a concept that first became popular as a result of a 1944 study by Alvin Hansen and Harvey Perloff. During the 1960s, this so-called "perversity hypothesis" was challenged by several economists who demonstrated that in the aggregate State and local government behavior had become increasingly countercyclical with each succeeding post-World War II business cycle.

However, the most recent recession of 1974-75 saw many State and local governments, in order to balance their budgets, cut expenditures and initiate tax rate increases--both of which can worsen a recession. At the same time, of course, there were increases in transfer payments and decreases in tax take (at existing tax rate levels) at the State and local level which were a direct result of the recession and which tended to dampen it.

Objectives of the Public Works Act

Title II of P.L. 94-369 attempted to address the problem created by these procyclical activities on the part of State and local governments. The program uses the unemployment rate both as a trigger to control the total flow of Federal funds to jurisdictions and as a mechanism for determining how much a particular jurisdiction will receive.

The approach to fiscal policy contained in Title II is new. Previously, programs to provide automatic increases in Federal spending during a recession focused primarily on transfer payments such as unemployment insurance. This new approach, referred to in the economic stabilization literature as "formula flexibility," focuses on formula grants rather than automatic alterations in transfer payments. Title II should be carefully examined as one of a class of new automatic stabilizers.

One major obstacle encountered in evaluating Title II flows from the multiplicity of its objectives. It appears that the program is designed to achieve three objectives:

1. Maintenance of public employment;
2. Maintenance of public service; and
3. Countering the recession.

While the objectives need not be mutually exclusive, reconciling them requires careful determination of the priorities. For example, the efficiency with which the first two objectives are achieved is critically dependent on the targeting of the funds while the third objective requires careful timing.

The third objective--stimulating a lagging economy--is an important fiscal goal. However, if the third objective were intended to be the primary concern of the program, then we have some reservations about the relative effectiveness of this program as compared with other possible approaches. Whether national fiscal policy is better implemented by having the Federal Government operate indirectly through State and local governments or by the Federal Government implementing fiscal policy directly is an unsettled and often debated issue. Nonetheless, the Federal Government can stimulate the economy directly through tax reductions or increased direct spending without using the State and local sector as an intermediary. There is reason to believe that the impact on the economy would be felt more rapidly through a direct approach.

If the stimulus is implemented indirectly through State and local governments, as in Title II, there are a number of built-in lags. For example, there are lags in collecting data from all State and local governments, calculating their allotments, and making the payments. There are also lags in spending the funds because the States and localities must go through their own processes of deciding how to spend the money. Our preliminary findings indicate, for example, that in this particular case, Federal payments were first made in the Autumn of 1976 and it appears that a significant portion of them have neither been appropriated nor spent by the States and localities at this date.

Consequently, with respect to countering a recession, direct action by the Federal Government appears likely to have a more rapid effect than a formula allocation of funds to State and local governments. But this was only one of the three objectives of the program and may well have been secondary to the goal of enabling State and local governments to maintain their normal level of employment or of services. By its very nature, direct spending by the Federal Government is unlikely to have a direct or significant effect on achieving these objectives.

I would like to turn explicitly to these other objectives, that is, the maintenance of public sector employment and the maintenance of basic services of State and local governments. To achieve these objectives requires a recognition that State and local budgetary problems at any point may reflect either short-term changes in the national economy, which we refer to as cyclical changes, or longer-term changes in the economic base and demographic characteristics of a particular jurisdiction, which we refer to as secular changes. Both cyclical and secular forces will affect both the revenue and expenditure sides of State and local budgets.

Attempting to deal only with the cyclical component (that part which is due to national recession) suggests compensating in terms of the budgetary disruption brought on by cyclical downturns. However, measuring that disruption is not an easy task. When we attempt to measure it by looking at the extent of corrective budget balancing actions taken by State and local governments, as the JEC did in a recent survey, the result may actually be a survey of actions taken in response to both cyclical and secular forces. Indeed, quoting from the JEC survey:

> The resulting $6.9 billion in tax and expenditure adjustments represent an average 3.5 percent adjustment for the total SL sector. However, the vast majority of budget adjustments will occur in the high unemployment SL governments. These governments will often be forced to make adjustments that amount to 7 or 8 percent of their total operating budgets. (JEC, p. 20)

Unfortunately, these may be the very governments whose observed expenditure reductions and discretionary tax increases are not the result of cyclical fluctuations, but rather of long-term tax base deterioration attributable to demographic changes and locational choices.

We are now attempting to develop more precise empirical measures of cyclical budget disruption as a basis for considering alternative ways of allocating the funds. Our analysis of these measures will appear in our report early next summer. Such measures must take account of the non-discretionary or automatic tax changes and expenditure changes built into the budgetary structure of the governmental unit. For example, units that rely more heavily on broad-based income related taxes such as sales and personal income taxes and where expenditures include large income transfer programs (AFDC and Medicaid) will suffer relatively larger disruptions than other units. If funds flow to jurisdictions that are not seriously impacted by cyclical disruption or flow in larger quantities than are indicated by the extent of that disruption, then at least part of the allocation can be expected to go toward State and local tax relief. This may stimulate the economy by increasing private sector spending power, but it does not contribute directly to the maintenance of public employment and public services.

<u>The Nature of the Secular Problem</u>

Because we believe the cyclical problem is separate from those that are associated with regions and governmental units experiencing long-run economic decline, we do not believe it is efficient to attempt to address both sets of problems with one allocation formula based on a single measure of need. Consequently, we are working on measures of secular decline which can be used, if the Congress wishes, to give separate recognition to the problems of secular decline. The budget problems that such units face, in addition to those brought on by fluctuations in business activity, seem clear enough. Many jurisdictions, particularly older central cities, have been experiencing loss of population and loss of jobs and have a serious problem of tax base erosion. With jobs and retail sales moving to the suburbs, or to other regions of the country, the revenues from property, sales and income taxes are increasing at a very slow rate, if not actually decreasing. At the same time, the need and demand for public services has continued and even increased due to the aging of the capital and housing stock of the city and the special needs of the remaining population.

An example of secular decline and the problems that it creates for a city can be seen in New York City. In a report to be issued shortly, we are assessing the impact of the movement of population, jobs, and business activity out of New York City and the New York City metropolitan area to other geographical regions of the country. This secular decline has created a fiscal problem of substantial proportions for New York City since these movements out of the City have eroded and are likely to continue to erode its tax base. This problem of secular decline added to the problems that the City faced during the recessions of 1970 and 1974-75. The City has had, and will continue to have, grave difficulty in coping with these problems and bringing its budget into balance by 1978.

For the 5-year period of the early 1970s, New York City's population declined by 327,200 persons, and manufacturing employment has fallen at an average rate of 48,000 jobs per year since 1969. The City has experienced the loss of some business firms, declines in business activity, and substantial growth in the amount of vacant office space.

The core problem of New York is not unique to that City. Other cities have experienced dramatic secular decline in the last decade, with some jurisdictions experiencing employment and population losses as great as 25 percent. Out-migration of economic activity may be advantageous for the business firms and individuals involved, but it imposes burdens on State and local budgets. These hardships may take the form of increased welfare costs as well as increased maintenance and decreased taxes which derive from the underutilization of public and private infra-structure (housing and office space, for example). The extent to which these problems warrant Federal intervention is a matter which ultimately must be decided by the Congress.

Applying the Formula to These Problems

The fact that a jurisdiction may face either cyclical or secular problems (or both) raises questions as to whether or not the present formula in Title II effectively responds to these problems. Our work to date leaves us somewhat doubtful.

The triggering mechanism for the appropriation of funds under Title II of the Public Works Employment Act is a national unemployment rate of 6 percent. The national unemployment rate s but one indicator of economic activity, and it is generally not considered to be the best indicator. For one thing, it has a tendency to lag several months behind the real level of economic activity. The recession phase of the business cycle is defined as "two continous quarters of decline in Gross National Product," and increases in the unemployment rate generally follow declines in GNP. Thus, reaching a specified unemployment rate is not likely to coincide with entering a recession. Other indicators, such as changes in the unemployment rate (rather than an absolute level of unemployment) or declines in GNP may be more reliable indicators of economic activity and recessions.

Furthermore, in looking at State and local jurisdictions, the unemployment rate does not distinguish between the cyclical and secular economic problems.

In addition, the actual allocations are based partly on General Revenue Sharing allocations, and we are investigating the sensitivity of the revenue sharing formula to cyclical economic activity. Revenue sharing allocations to State and local jurisdictions are based generally on three factors: population, tax effort (total State-local net tax collections divided by State personal income), and State per capita income. None of these are necessarily good indicators of the impact of the business cycle on a State's budget. To improve the sensitivity of the allocations to cyclical disruption, it would be important to consider those factors, particularly on the revenue side, which are most responsive to fluctuations in economic activity. The more income sensitive a particular tax source is, the greater the cyclical disruption is likely to be.

At present, the manner in which the unemployment rate is used in the allocation formula appears to shift funds toward areas that are suffering from secular decline and have long-term high unemployment rates. Our preliminary analysis indicates that this may be the situation. However, further work is needed before a definitive conclusion can be drawn. Our presumption is that the legislation was intended to concentrate on problems associated with the business cycle, rather than the long-term decline of areas. If so, and if our preliminary conclusions are borne out, the Congress may wish to reconsider the use of the unemployment rate as a basis for allocating funds. If the Congress also wishes to address the matter of assistance to jurisdictions experiencing secular decline, we believe a formula could be designed which would more directly recognize that problem.

Preliminary Observations from Field Work

I would like now to turn to another aspect of GAO's current efforts. As part of our investigation of the impact which anti-recession assistance payments have had on State and local government operations, we are gathering information on selected State, city, and county governments which are geographically dispersed throughout the country. At each location we are preparing detailed analyses of the trends in revenues, expenses, and public employment; the status and use of anti-recession funds received; and the impact these funds have had on each government's operations. Our work in these locations is progressing smoothly, and we expect to report the results of this work by July 21, 1977.

While our field work is far from complete, these hearings do give us the opportunity to discuss our preliminary work in 21 of the locations--6 States, 10 cities, and 5 counties. To date the 21 governments have received $112.7 million in anti-recession funds. Selected data on these governments is included in Exhibit I.

As set forth in the Conference Report, Title II was designed to meet three criteria as an anti-recession program:

-- To provide assistance directly into the economy, with as little administrative delay as possible,

-- To provide selectively targeted assistance, so that only those governments substantially affected by the recession would receive funds, and

-- To phase itself out, as the economy improves.

Based on our preliminary observations, the current program does not meet the first two criteria. The effectiveness of the phasing-out provision remains to be evaluated.

Even without considering the initial delays in getting the program on its feet, anti-recession funds are not getting into the economy quickly. As of February 7, 1977, of the 21 governments, only

-- 12 had appropriated some of the November 17, 1976, payment,

-- 9 had appropriated some of the January 5, 1977, payment, and

-- 6 had actually spent some of the funds.

This slowness results partly because the governments could not plan in advance on receiving a specific amount, as is possible, for example, under general revenue sharing. Another reason for the delays is the complicated budgetary process each government faces. As you know, legislative calendars are planned well in advance and are often quite full.

Despite these inherent delays, it does appear that most governments can legally "spend" the funds within six months. Current regulations of the Office of Revenue Sharing at the Treasury Department only require a government to appropriate or obligate anti-recession funds within six months in order to meet the six month expenditure deadline specified in Title II. As a result, some governments do not feel the need to "spend" the payments within six months. Consequently, the economy is not being stimulated as quickly as intended.

To remedy this situation, we are in the process of formally proposing to the Office of Revenue Sharing that it revise its regulations to require all governments not prohibited by State or local laws to "spend" the funds within six months.

Although nine of the 21 governments had not appropriated any of the funds, all but one had made plans for using some or all of the first payment. As shown in Exhibit I, about half of the governments plan to use some or all of the anti-recession funds for salaries. More specifically, they plan to (1) bring back laid off employees or refill positions; (2) reduce layoffs; (3) pay current employees; or (4) hire either temporary or permanent employees.

Because the anti-recession program is temporary and quarterly payments fluctuate, however, some governments seem reluctant to hire permanent employees or to start or resume services that later might have to be funded with self-generated revenues.

Other uses of anti-recession assistance vary greatly. Several of the governments plan to use the funds for maintenance and repair; two plan to fund pay raises; and two plan to fund Medicaid payments.

Although the majority of governments plan to use the funds to create some jobs and for basic services, it is not clear in all cases that the funds received are being used to overcome recession-related financial problems. Some of these governments clearly have been affected substantially by the recession while others seem to have been more affected by chronic problems, such as declining populations and long-term unemployment. These are the secular problems which were discussed previously.

The financial health of a government obviously affects its ability to cope with recessionary pressures. Some of the 21 governments made significant budgetary adjustments such as raising taxes, laying off employees, and cutting expenditures while other governments were making countercyclical budgetary adjustments such as reducing taxes or spending accumulated surpluses.

In summary, data from these 21 governments appears to support the view that (1) anti-recession assistance has not been targeted effectively to those governments substantially affected by the recession and that (2) "excess unemployment" as defined in the current legislation is not a very good approximation of the recession's impact. It is apparent that a more precise measure is needed to distinguish between cyclical and chronic problems. There are serious problems in the availability of reliable data, but part of our current effort is devoted to identifying measures which will permit this distinction to be made.

Improvements could be made to insure that the money is concentrated on those governments having the greatest need. As shown in Exhibit I, the 21 governments currently receive a very small payment in proportion to their total operating budget, ranging from .37 to 3.62 percent. In some cases, we question whether the payment will have any significant affect on a government's financial condition and consequently on the level of services which the jurisdiction provides.

In a future report to the Congress we hope to address these issues in considerable depth and recommend short-run and long-run improvements.

That concludes my prepared statement, Mr. Chairman. We will be happy to try to answer any questions you may have.

Government	Average first 3 quarters 1976 unemployment rate	Per capita antirecession assistance received for all three quarters	Three quarter payments as a percent of current budget	Major type of planned expenditures as of 2/7/77
States				
Iowa	5.3%	$ .28	0.04%	Medicaid payments
Virginia	5.6	.38	0.04	Prevent layoffs
Alabama	7.0	.98	0.16	Medicaid payments; corrections
Oklahoma	7.6	1.12	0.14	Salaries of current employees
California	9.9	2.36	0.33	Deferred maintenance; hire temporary employees
Florida	10.4	2.07	0.31	Corrections
Cities				
Fort Worth, TX	6.2%	$ .96	0.37%	Hire new employees
Norfolk, VA	6.4	1.89	0.30	Refill positions
St. Paul, MN	6.8	1.45	0.55	Tree disease control
Honolulu, HA	8.4	3.03	0.97	Pay raise
Spokane, WA	8.6	3.14	0.75	Repair and maintenance
Cincinnati, OH	9.5	4.45	0.51	Prevent layoffs
Los Angeles, CA	10.5	3.52	0.98	Salaries of current employees
Miami, FL	12.4	7.28	1.89	General fund operating expenses
Detroit, MI	14.5	10.90	1.72	Recall or hire new employees; purchase equipment
Oakland, CA	15.1	6.42	2.21	Pay raise
Counties				
Hennepin, MN	6.0%	$ .52	0.15%	Public works
Fulton, GA	7.2	1.63	1.09	Salaries of current employees
Norfolk, MA	8.1	.10	0.33	No plans
Multnomah, OR	10.3	2.43	1.15	Maintenance
Robeson, NC	10.9	4.72	3.62	Hire new employees

EXHIBIT 1