



COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

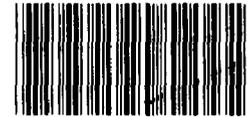
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JUNE 12, 1980

B-199053

The Honorable L. H. Fountain  
Chairman, Subcommittee on Intergovernmental  
Relations and Human Resources HSE01505  
Committee on Government Operations  
House of Representatives

The Honorable Bill Bradley  
Chairman, Subcommittee on Revenue Sharing,  
Intergovernmental Revenue Impact, and  
Economic Problems  
Committee on Finance  
United States Senate  
SEN 04/20



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Subject: [More Flexibility Needed in Setting Revenue  
Sharing Adjustment Reserves] (GGD-80-82)

We reviewed the size of the Revenue Sharing adjustment reserve fund to determine if the Secretary of the Treasury had withheld only funds necessary to cover expected claims. Because these reserves defer authorized budget expenditures, they should not exceed levels necessary to reimburse known and expected claims. The Office of Revenue Sharing accumulates the reserves by withholding a portion of State and local government entitlements (not exceeding 0.5 percent), and it uses them to cover adjustments resulting from recipient claims. Currently the reserves total \$112 million even though the Office expects to distribute only about \$2.5 million in claims during fiscal year 1980.

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The Revenue Sharing adjustment reserves for most States are substantially larger than necessary but, in a few States, because of larger than normal claims, they are or have been too low. Maintaining larger than necessary reserves delays revenue sharing recipients from receiving funds to which they are entitled and maintaining smaller than necessary reserves precludes the Secretary from making timely adjustments for underpayments. The current imbalance between the size of the reserve accounts and the size of past claims has occurred for the following reasons.

--The 0.5 percent ceiling on the amount the Office can withhold inhibits its ability to make large adjustments when necessary.

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--The Secretary withholds the maximum 0.5 percent for each State each time funds are withheld, although most States have required less than a tenth of this for adjustments and the act allows smaller withholdings.

We conducted this review in May and June of this year at the Office of Revenue Sharing's headquarters in Washington, D.C. We interviewed agency officials and analyzed data to evaluate how the Office has used the obligated adjustment reserves. We also interviewed an official at the Census Bureau to ascertain the possible implications of current litigation on reserve size adequacy.

#### THE REVENUE SHARING ADJUSTMENT RESERVES

Title I of the State and Local Fiscal Assistance Act of 1972, commonly known as the Revenue Sharing Act (31 U.S.C. §§ 1221 et seq.), was enacted to provide general financial assistance to State and local governments. By the end of fiscal year 1980, the revenue sharing program will have provided about \$55.7 billion to 39,000 recipient governments over 11 entitlement periods.

The Secretary of the Treasury often makes adjustments for under or overpayments discovered after funds have been allocated to participating governments. These adjustments occur generally because of data errors and occasionally because of changes in governmental structures. To assure funds remain available to make these adjustments, the Secretary, as authorized by the Revenue Sharing Act, has established reserve accounts by withholding up to the maximum allowable 0.5 percent of entitlements.

Currently, the Secretary maintains two separate reserves: a national reserve totaling \$22 million, which the Office uses for adjustments necessary for entitlement periods one through seven and individual State reserves totaling \$90 million, which the Office uses for the remaining periods. By regulation in 1973, the Secretary established the national reserve as a single pool of funds to make adjustments to governments within any State regardless of the amounts the State contributed. The individual State reserves were specifically authorized by the 1976 Revenue Sharing amendments. Adjustments applicable to periods after entitlement period seven come from the respective State reserve and are limited to the amounts within that reserve.

#### STATE RESERVES FOR MOST STATES ARE EXCESSIVE

The law does not require equal reserves to be withheld from all States--it provides that the Secretary may withhold

in the individual State reserves what is sufficient to pay adjustments (up to the 0.5 percent limit). Nevertheless, the Office of Revenue Sharing has always treated all States the same by withholding, whenever reserves have been withheld, the maximum amounts. This practice of withholding the maximum reserve is clearly excessive for many States and has resulted in some States accruing reserve balances 20 or more times greater than they have needed.

The effects of accumulating reserves by withholding maximum amounts from all States can be seen by comparing the amounts withheld from entitlement periods 8, 9, and 11, with the percent of reserves used by the States. No funds were withheld for entitlement period 10.

Percent of Reserves Used  
by States

<u>Percent of reserves used</u>	<u>Number of States (including the District of Columbia)</u>	<u>Dollars withheld (note a)</u>
0	11	\$ 9,870,548
more than 0 to less than 5	27	63,216,324
5 to less than 10	4	6,242,034
10 and greater	<u>9</u>	<u>14,108,627</u>
Total	<u>51</u>	<u>\$93,437,533</u>

a/Excludes \$22 million in national reserves.

As shown above, 38 States used less than 5 percent of the \$73 million withheld in their reserves.

On the other hand, situations occur when claims on the reserves may be much larger than normal. In such instances, the inflexibility of the legislative 0.5 percent maximum limits the Office's ability to pay the approved claims.

In Utah, for example, one large county was underpaid by \$772,378 in Federal fiscal year 1979 (entitlement period 10), but the funds in the State's reserve account totaled only \$528,848 on May 12, 1980. Although the Office withheld Utah's maximum reserves for periods 8, 9, and 11, the total revenue sharing funds the State receives are relatively small. Consequently, it takes more than three entitlement periods to build up sufficient reserves to meet a single large adjustment. Until the Office collects sufficient reserves, this county will

be deprived of its full entitlement. To date the local government has not received any reimbursement for this underpayment.

NATIONAL RESERVE IS LARGE WHEN  
COMPARED WITH PAST USAGE

The Office of Revenue Sharing currently has a \$22 million national reserve for the payment of claims applicable to entitlement periods one through seven. Our analysis of prior activity in this reserve shows that the \$22 million is substantially greater than past claims experience would justify.

In September 1977, the Office redistributed \$50 million from the national reserve to revenue sharing recipients. Since that time, the Office has paid less than \$64,000 in adjustments from the national reserve, as shown in the following table.

Payments Made From National Reserve  
Since September 1977

<u>Entitlement period</u>	<u>Amount</u>
9	\$52,889
10	1,522
11	<u>9,255</u>
Total	<u>\$63,666</u>

As can be seen in the table, payments since entitlement period nine have been minimal.

THE OFFICE OF REVENUE SHARING'S  
RATIONALE FOR SIZES OF RESERVES

Office officials agree that the \$112 million in State and national reserves substantially exceed the level needed to meet known potential liabilities and anticipated normal usage. They explained, however, that presently two lawsuits are pending against the Government for claims which the Office estimates approximate \$2.8 million. While the two suits involve only two local governments, the Office believes an adverse decision could result in follow-on litigation by other local governments. Because of this, Office officials believe prudent management requires a substantially larger reserve than would be necessary in the absence of litigation.

Approximately \$700,000 of the pending litigation involves claims which are applicable to entitlement periods one through seven and, if settled against the Federal

Government, the Office plans to pay out of the national reserve. The Office, however, can no longer withhold entitlement funds for the national reserve. In view of the uncertain effects that pending litigation may have in generating follow-on litigation against entitlement periods one through seven, we believe the available national reserve should be retained until a reasonably good assessment of the liabilities that may result can be made.

The situation is somewhat different for the State reserves.

If the Secretary were given greater discretion in deciding the appropriate amount to withhold from States, we believe overall State reserve levels would, in most cases, be greatly reduced. Essentially, reserve levels could be determined by expected claims arising from routine data or computational errors and known or expected liabilities. Large unforeseen claims could be paid by larger entitlement withholdings at the time the amounts can be reasonably estimated.

Unexpected claims which occur in excess of the normal reserve withholding could be covered by withholding a larger portion of subsequent period entitlements. At times this larger withholding could exceed the current 0.5 percent limit but it is unlikely, based on past experience, that withholdings would ever have to be much greater. Since the State reserves were established in 1977, for example, the largest value of a single claim made in any one State has been less than 2 percent of its annual entitlement payment. Since the program began in 1972, a claim has never exceeded 5 percent of a State's annual entitlement payment.

According to a May 1979 Office analysis, if State reserve balances were based on average and expected claims levels for the respective States, it would be possible to reduce State reserves from \$90 million to about \$26 million and still maintain an adequate cushion. The \$64 million freed from the reserves would then be redistributed among the localities within each State on the basis of their respective percentage share of the last entitlement period. For example, if this redistribution were made, recipients in California, the State with the largest reserves, would receive over \$9 million. The Office took no action on the analysis because of concern over the possible implications of current litigation...

Increasing the ceiling would provide the Office the flexibility needed to deal with contingencies, and would allow

the Secretary to redistribute a substantial portion of the current State reserves. The Secretary would no longer have to build up reserves in anticipation of contingencies, such as litigation which may not occur. Even if a contingency does result in a substantial readjustment, recipients who would lose a portion of their entitlements would be better off than if the reserves were taken out over earlier periods in smaller increments. The contributions to the reserves and adjustments made under either case affect the same recipients. Making adjustments out of later entitlements would allow recipients immediate use of their funds rather than foregoing their use while they are held in reserve to satisfy claims that may never occur.

### CONCLUSIONS

Giving the Secretary of the Treasury greater flexibility in varying reserve withholdings by raising the 0.5 percent ceiling would minimize the need for larger reserves. With less restrictive provisions on withholding reserves from entitlements, the Secretary of the Treasury could greatly lower reserves by basing them on each respective State's normal claim. The Secretary could pay unusually large claims by temporarily increasing withholdings from affected States as the claims occur or become imminent. Increasing the ceiling would allow local governments to use a greater portion of their revenue sharing funds when they become entitled, instead of holding the funds in non-interest bearing Government accounts. It would also allow the Secretary to reimburse governments which had received unusually large underpayments by temporarily increasing reserve withholdings from subsequent entitlements of affected States.

Even without legislative amendments, however, the Secretary can reduce reserve levels by more flexibly managing the reserves according to the differing needs of individual States. Although most States use only a very small portion of their reserves, each State has had the maximum amount withheld each time reserves are withheld. This policy has resulted in accumulating balances for most States that are 20 or more times larger than their largest annual claim against the reserve.

The \$22 million national reserve should be retained until pending litigation is settled and a reasonably good assessment of potential liabilities is made.

### OFFICE OF REVENUE SHARING COMMENTS

On June 4, 1980, we discussed our observations with the Office's Director and his staff. The Director agreed that the State reserves should be reduced and stated that the

Office was considering how this could best be done. He also stated, however, that he would like to give more thought to whether any changes in the legislative ceiling are necessary.

The Director believed that the national reserve should be retained until current litigation is settled and the effects on potential follow-on litigation can be determined.

#### RECOMMENDATION TO THE SUBCOMMITTEES

We recommend that the Subcommittees amend section 102(c) of the State and Local Fiscal Assistance Act of 1972 [31 U.S.C. 1221(c)] to raise the ceiling from 0.5 to 5 percent on the amount which the Secretary of the Treasury may withhold from entitlements for reserves. The largest claim made in any one State in a single entitlement period has never reached 5 percent.

#### RECOMMENDATIONS TO THE SECRETARY OF THE TREASURY

We recommend that the Secretary of the Treasury

- discontinue withholding a fixed percent for all State reserves and, instead, withhold amounts on the basis of the individual States' needs; and
- reevaluate current State reserves and redistribute those funds which are greater than needed to pay reasonably foreseeable claims.

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Copies of this report are being sent to the Secretary of the Treasury and other appropriate congressional committees.



Comptroller General  
of the United States