Economic Implications of Revenue Sharing

by E. C. HARWOOD

AMONG the measures that President Nixon recently proposed for reforming the welfare system was a plan for "sharing" federal government revenues with state and local governments. On August 13 the President sent a message to Congress describing this plan.

He emphasized four major aspects. First, the total amount of federal revenues to be turned over to state and local governments would be a percentage of personal taxable income. (Because the amount would not be a percentage of federal revenues, it would not vary as a result of future changes in federal taxes.) The President proposed that federal revenues equal to one-third of 1 percent of such income, or an estimated $500 million, be turned over to state and local governments during the second half of fiscal year 1971. During subsequent fiscal years this would increase gradually to 1 percent in fiscal years 1976, when the amount of federal revenue thus to be turned over would be an estimated $5 billion. The amount would increase an estimated $500 million each year thereafter.

Second, federal revenue to be turned over would be allocated among the 50 states and the District of Columbia primarily on the basis of each state's share of national population. However, the allocation would be "adjusted for the state's revenue effort," so that states where revenue is a larger poportion of personal income would receive a larger allotment than other states where revenue is a smaller proportion. This adjustment purportedly would "provide the states with some incentive to maintain (and even expand) their efforts to use their own tax resources to meet their needs."

Third, the amount of federal revenue that each state would share with its local governments would be based on the relative amounts of state and local financing in each state. The shared revenue received by each local government would be proportional to its share of total local government revenue raised in the state. Thus, governments of large cities, which raise a large amount of revenue per capita, would receive a larger share than those of small towns.

Although not stated by the President, rather than encouraging frugality among state and local government authorities, this method of "rewarding" those among such authorities that impose the proportionately greatest tax burden on their constituents more probably would foster a competitive upsurge in state and local taxes.

Fourth, administrative requirements such as reporting and accounting would be "kept at a minimum." Federal government authorities would not specify purposes for which state and local governments would use funds provided from federal revenues. Thus, state and local government authorities would obtain funds for spending without having to extract them from taxpayers or to justify their expenditure. Such authorities therefore would become less responsive to their constituents and more subservient to federal government authorities.

The President asserted that the proposal for revenue sharing "marks a turning point in federal-state relations, the beginning of decentralization of government power, the restoration of a rightful balance between the state capitals and the national capital." Raising revenues by the coercive power of the federal government and spending

them without accountability to taxpayers would not seem to us to constitute a "decentralization of governmental power," even if such revenues were spent wisely.

Mr. Nixon asserted that "Under our current budget structure, federal revenues are likely to increase faster than the national economy. At the local level the reverse is true. State and local revenues based on sales and property taxes do not keep pace with economic growth, while expenditures at the local level tend to exceed such growth. The result is a 'fiscal mismatch,' with potential federal surpluses and local deficits."

The nearly unbroken succession of federal budget deficits during recent decades does not support the theoretical notion of "potential federal surpluses." If such surpluses do occur in the future reducing federal taxes that discourage enterprise would be the most economic way of reducing them. A more accurate description of state and local revenues than that provided by the President is that they have not kept pace with the propensity of politicians to spend them.

The President noted that during the past half decade spending by the federal government, in an attempt to alleviate social ills, was on a scale never before witnessed. "Yet, despite the enormous federal commitment in new men, new ideas and new dollars from Washington, it was during this very period in our history that the problems of the cities deepened rapidly into crises."

He noted also that "The problems of the cities and the countryside stubbornly resisted the solutions of Washington; and the stature of the federal government as America's great instrument of social progress has suffered accordingly—all the more so because the federal government promised so much and delivered so little." To solve these problems, he proposed "to enlist the full potential of the levels of government closer to the people."

We do not doubt that experimenting by many local governments might provide solutions to some social problems more economically than could centrally planned experiments by the federal government. However, the failure of the latter's attempts described by the President prompts questions such as, can expenditures of more public funds solve some social problems? and, have important aspects of such problems been overlooked?

Specifically, have any local governments acquired adequate amounts of revenue from increases in site values attributable to improvements provided by, or population increases in, the community? How might a shift of real estate taxation from improvements to site values affect such social problems as blighted or slum areas in cities? Answers to these questions have been found and have been described in Institute publications.* Unfortunately, President Nixon and his advisors apparently have not asked such questions and have overlooked or ignored some answers that already have been found.

Under the socioeconomic arrangement outlined in the Constitution of the United States, individuals in municipalities and states collectively decide what portion of the wealth that they produce is to be made available to local and state authorities and used for public purposes. These authorities are accountable to their constituents for the methods used to obtain wealth for public purposes and for the effectiveness with which such wealth is so used. Citizens thus can control the amount of public revenue, the methods of obtaining it, and its use. Communities are free to experiment with various

* See "How to Make Slums and Create Barbarians" in *Economic Education Bulletin* for October, 1968 and "The Southfield Story of Creative Taxation" in *Research Reports* for March 31, 1969.

methods of obtaining and using public revenue, and any community has the opportunity to adopt more economic methods and uses than another develops.

Providing revenue obtained by the federal government to state and local governments would be a radical departure from the arrangement just described. Increasing amounts of individuals' wealth throughout the nation would be obtained by such uneconomic methods as the steeply progressive federal individual and corporate income taxes, which discourage enterprise; and state and local authorities would be encouraged to use such wealth without being accountable to their constituents. Moreover, providing a larger allocation of federal revenue to states that already take a larger proportion of personal income in taxes would provide an incentive for states to take for public use even more of the individual wealth produced. Adoption of the proposal thus would encourage consumption of wealth for political panaceas and discourage its use for capital formation. It would encourage taking more from the "public trough" and would discourage efforts of individuals to help themselves.

Adoption of the proposal would result in taking resources from successful processors of wealth and redistributing them to less successful ones and to those who process no wealth at all. The ability of more successful processors to expand their processing activities and provide job opportunities thus would be restriction. Adoption of the proposal would further implement in the United States the Marxian Socialist principle, "From each according to his abilities, to each according to his needs."

The misallocation of resources that would result from adoption of the proposal can be illustrated by describing what its effects would have been on mining communities where ore reserves became exhausted. When useful processing activity no longer was possible in such communities, they became "ghost towns" as people and capital equipment (resources) were diverted to other areas where useful processing activity was feasible. The proposal to provide federal revenues to communities throughout the nation, whether or not useful processing activity was feasible in them, would tend to perpetuate the existence of potential "ghost towns" by subsidizing people and their use of capital equipment in uneconomic or marginally useful processing activity. Such misallocation of resources would result in processing a smaller total of wealth, and the nation would be poorer as a whole.

Like other schemes for redistributing wealth, the provision of federal revenue to state and local governments would induce politicians in and out of office to attempt to buy votes by proposing large increases in the amount to be provided. Moreover, it would increase the opportunity for logrolling in Congress, where votes for increasing the amount to be provided could be exchanged for votes for other federal expenditures politically beneficial to their sponsors.

To summarize, the provision of federal revenue to state and local governments would constitute an unwarranted redistribution of wealth that would have undesirable economic consequences for the nation. Far from being a decentralization of governmental power, such provision would increase the power of government authorities to interfere with the economic activities of individuals. Eliminating uneconomic federal taxes and substantially reducing the total of revenues taken by the federal government would enable individual states and municipalities to choose how and how much wealth is to be taken for public purposes. Such steps would clearly help to decentralize governmental power.