Revenue Sharing Revisited

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I hesitate to discuss revenue sharing on still another occasion, since I have already exhausted myself in the public discussion of this simple but controversial idea. Moreover, now that a national administration has recommended revenue sharing, there are people who can defend it with superior resources than those I can command.

Nonetheless, it might be helpful to review the objectives and basic features of the original revenue sharing proposal and compare them with the plan developed by the Administration, and to discuss the major issues that still remain. To avoid suspense, I want to assure you that I still believe revenue sharing would make a significant contribution toward the improvement of federalism in this country, and I am delighted to welcome the President of the United States and members of his Administration into the club of revenue sharing enthusiasts.

Objectives of Revenue Sharing

The purpose of revenue sharing is to allocate to the states and local governments *on a permanent basis* a portion of the very productive and highly "growth-elastic" receipts of the Federal government. The bulk of Federal revenues is derived from income taxes, which rise at a faster rate than income as income grows. By contrast, state-local revenues barely rise in proportion to income.

State-local needs have outstripped the potentialities of their

The views presented in this paper do not necessarily represent those of the officers, trustees, or other staff members of the Brookings Institution. However, I am sure they reflect the views of Professor Walter W. Heller, who originated the modern version of the idea of per capita revenue sharing. In fact, we have collaborated so frequently in support of revenue sharing that it is now impossible to distinguish his ideas from mine on this subject. But this would be written more elegantly if he were co-author.

revenue systems at constant tax rates, with the result that tax rates have been pushed steadily upward throughout the postwar period and many new taxes have been added. Since state-local taxes are on balance regressive, the higher state-local taxes impose unnecessarily harsh burdens on low-income recipients. In addition, essential public services are starved by governors, mayors, and legislators who try to avoid the politically distasteful (and sometimes politically suicidal) choice of increasing taxes.

But why revenue sharing? Why not use the traditional categorical grant system to help relieve the financial burden of the state and local governments? The answer is that unrestricted as well as conditional grants are needed to achieve the objectives of federalism, and the system would be deficient without both types of grants.

Conditional grants are justified on the ground that the benefits of many public services "spill over" from the community in which they are performed to other communities. Expenditures for such services would be too low if financed entirely by state-local sources, because each state or community would tend to pay only for the benefits likely to accrue to its own citizens. States have a well-developed system of conditional grants to local governments for this reason. Additional assistance by the Federal government is needed to raise the level of expenditures closer to the optimum from the national standpoint.

Unconditional or general purpose grants are justified on substantially different grounds. The basic need for unconditional grants arises from the obvious fact that all states do not have equal capacity to pay for local services. The poorer states are simply unable to match the revenue-raising ability of the richer states.

Even if the Federal government adopted a negative income tax which lifted all poor persons to the officially defined poverty lines, the low income states could not afford to support public services at a level that approached adequacy.

As a matter of fact, the poor states have been making an average tax effort in recent years (much better than average, if an allowance is made for the fact that the first $500 or $750 per capita has little or no capacity to pay), and it is understandable that their fiscal plight has not been alleviated to any substantial degree.

A second reason for unconditional grants is that Federal use of the best tax sources leaves a substantial gap between state-local need and state-local fiscal capacity. Moreover, few states push their rates much higher than the rates in neighboring states for fear of placing their citizens and business enterprises at a disadvantage. This reasoning justifies some Federal assistance even for purely state-local activities, with the poorer states needing relatively more help because of their low fiscal capacity.

Thus conditional and general purpose grants have very different functions and these cannot be satisfied if the Federal system were limited to one or the other. Considering the large unmet needs throughout the country for public programs with large spillover effects, the adoption of revenue sharing should not be the occasion for reducing conditional grants. Indeed, to meet these needs, it will be necessary to allocate Federal funds simultaneously to revenue sharing and to the conditional grant programs. Conversely, the fact that there is an urgent need for more generous financing of the categorical grants is neither a sufficient nor a necessary condition for abandoning the revenue sharing idea.[1]

Major Features of the Original Plan

The core of the original plan was the regular distribution of a specified portion of the Federal individual income tax to the states primarily on the basis of population, and with no strings attached on the types of expenditures that could be made with these funds. The essential features of the plan are as follows:

1. *A percentage set aside.* The Federal government each year would set aside for distribution to the states a certain percent of the federal individual income tax base (i.e., taxable income of individuals

[1]Most critics of revenue sharing often overlook the point made in this paragraph. Walter Heller and I have always emphasized that revenue sharing should be accompanied by *increased,* not reduced or constant, categorial grants. Thus, Table 2 of the Musgrave-Polinsky paper in this volume does not contain an accurate representation of how our version of revenue sharing would operate in practice. Using the Musgrave-Polinsky definition of state-local deficiencies and the illustrated categorial grant programs, our revenue sharing plan would be a combination of one of the three top lines in their Table 2 with one or more of the succeeding five lines. For example, the additional federal transfers of $5, $10, and $20 billion might be divided equally between the Javits version of revenue sharing (line 3) and welfare assistance (lines 4 or 5) or school assistance (lines 5 or 6), or in some other reasonable proportion. If this were done, revenue sharing would be much more effective in removing state-local deficiencies than Musgrave and Polinsky show in their Table 2 and might even do better than their categorical grant alternatives.

after deductions and exemptions). The plan was to begin with a 1 percent allocation that would increase, say, by .2 percent for five years, until it reached 2 percent. However, the particular percentages were acknowledged to be illustrative and it was understood that the ultimate decision would depend on the elbow room in the Federal budget.

2. *Automatic allocations of grant funds.* The funds allocated to the plan would be distributed automatically to the states and local governments without annual appropriations. A trust fund arrangement was suggested for administering the plan to underscore the fact that the states and local governments should receive the funds free from the uncertainties and hazards of the annual appropriations process. However, there are other devices to achieve the same objective.

3. *Unrestricted nature of the grants.* There would be no constraints on the use of the funds by function, with the exception that highway expenditures were to be excluded, since there is a special Federal trust fund with its own revenue sources earmarked for this purpose.

4. *Distribution formula.* The basic method of allocating the funds would be in proportion to population. But the plan envisaged modification of straight per capita grants in two respects: first, the per capita amounts would be multiplied by a tax effort factor, to provide an incentive for states and local governments to increase their own fiscal effort; and, second, a small proportion of the total funds available, say 10 percent, would be allocated (again on a per capita basis) to the lowest income third of the states.

5. *Pass-through to local governments.* The original plan had no mandatory pass-through to the local governments. Some supporters of revenue sharing felt from the beginning that a minimum pass-through should be provided in the legislation. Others believed that it would be unwise to insist on a particular allocation between the states and local governments, because conditions varied greatly throughout the country and no one formula could take them fully into account.

The Administration Proposal

It is remarkable that the Administration's proposal follows the original plan almost to the letter. The amount set aside is a fraction of the individual income tax base, rising by 1976 to 1 percent of taxable income four years earlier (to allow for the inevitable delay in publication of Statistics of Income). The grants are on an unrestricted basis – even highway expenditures are permissible – and the state allocation is on a per capita basis modified by tax effort. To assure an automatic flow of funds, a permanent and indefinite appropriation would be authorized to cover the stipulated percentage of taxable income.

The innovation in the Administration proposal is a specific mandatory pass-through of a portion of the grant funds to the local governments, a feature that was left open in the original. Local governments in any state would receive at least the same proportion of state-local general revenues that they accounted for in the most recent year for which Census data are available. I shall discuss this feature of the proposal in more detail later.

Some Remaining Questions

Revenue sharing has generated numerous proposals for reform of the Federal-state-local fiscal system, and practically everyone with a pet idea has proposed that it be attached to the revenue sharing bill. I shall confine myself to three points that seem to be of some significance.

1. Many have recommended a Federal income tax credit for state income taxes as a supplement or substitute for revenue sharing. For example, the bill drafted by the Advisory Commission on Intergovernmental Relations includes an income tax credit as well as revenue sharing. On the other hand, the Committee for Economic Development has endorsed the income tax credit, but opposes revenue sharing.

The income tax credit is a device to encourage states to adopt personal income taxes as part of their permanent revenue systems. This is a laudable objective and I would support the credit if there were room in the federal budget for both the credit and revenue sharing. However, the credit must be given a low priority when the Federal budget is tight, because it has a perverse distributional effect between poor and rich states. Since the amount of the credit is a positive function of income, it is by its very nature more helpful to rich states than to poor states. (I know of no feasible way of correcting this perverse effect.)

Furthermore, the benefits of the credit for the 37 states that now have income taxes would accrue in the first instance to the taxpayers as a tax reduction, rather than as added tax receipts of their governments. Fiscal resources for state-local programs would not be augmented unless the states raised tax rates, and the entire Federal revenue loss would be available for public services only if the states raised tax rates by the full amount of the credit.

In present circumstances, Federal fiscal assistance should flow directly into state and local government treasuries to avoid use of the Federal funds for tax reduction.

Finally, I see no reason why the Federal government should, at this time, penalize state governments that have already adopted a progressive revenue source and help those that have been laggard in progressive taxation. My own preference would be to add the revenue loss from the credit to the proposed revenue sharing funds and require all states to have effective income taxes (defined, say, as taxes that yield at least 3 percent of personal income) to be eligible for the revenue sharing grants.

2. Congressman Henry S. Reuss and others have been arguing that the Federal government should use its fiscal resources to help improve the management and administration of state and local governments. Virtually no progress has been made to eliminate unnecessary units of government, to consolidate units that are too small to operate efficiently, and to provide local services for natural geographic areas rather than on the basis of political subdivisions that make no economic sense. Mr. Reuss proposes that, along with revenue sharing, the federal government should finance a national effort to rationalize the state-local governmental structure and to provide incentives for efficient management.

There is no question that the state of affairs is deplorable, and some new dramatic device needs to be used to shake state-local officials out of their lethargy. Mr. Reuss would require only that state governments prepare a master plan and timetable for modernizing and revitalizing their governmental structures to be eligible for the revenue sharing grants. The details would be left to the states themselves.

Provided that this modification would not involve constraints on the spending of the revenue-sharing funds, it seems to me that the Reuss modification would have the desirable effect of focussing attention on an important national problem. Federal assistance for a country-wide effort to improve the governmental structure of our states and local governments might provide substantial benefits. The experiment is worth a try, since reform is so urgently needed in this area.

3. Revenue sharing would miss its mark if it failed to relieve some of the intense fiscal pressures on local, and particularly urban, governments. The question is not *whether* revenue sharing should put funds at the disposal of local governments, but *how*.

All states give aid to local units and most give significant amounts. As a matter of fact, the state grant-in-aid system for local governments is much more highly developed than the Federal grant system. In the aggregate, transfers from state to local governments account for more than a third of state expenditures and about 30 percent of local general revenues.

By contrast, Federal grants amount to only 18 percent of state-local revenues. Thus, even without any specific requirements, local governments would receive a third or more of any general funds the states might receive from the Federal government.

Nevertheless, in the light of urgent local needs and the observed tendency of some state capitals to shortchange their major central cities, I have been persuaded that an explicit "pass-through" rule may be desirable to recognize the legitimate claims of local government.

The two competing alternatives are those recommended by the Advisory Commission on Intergovernmental Relations (ACIR) and the Administration. The ACIR would confine the mandatory pass-through to local governments with populations of 50,000 or more. The Administration would distribute the funds on the basis of the present distribution of taxes levied directly by the states and local governments. The debate over these two approaches can become heated, but I am rather agnostic about this particular feature. The issue cannot be resolved on any scientific basis, and I would leave the matter to the judgment of the Congress where close political decisions should be made.

Conclusions

It is clear that, for the long pull, the states and local governments will be unable to meet their growing needs without substantial assistance from the federal government. Part of this additional assistance will come from specific grant programs. But the states and local governments will need supplementary assistance in the form of general aid to finance other essential activities.

Revenue sharing is designed to assist local as well as state governments. Even if the funds go initially to the states, it should be possible to design a mandatory pass-through to guarantee a fair share for local governments.

The plan would provide the states and local governments with a growing source of revenue from a tax source that is much more equitable than most of those now available to them. This would provide an additional margin to help them finance needed state programs and to improve their own grant programs for local governments. Revenue sharing may not be a panacea for all our ills, or even for the most virulent ones, but it would certainly help to strengthen our federal system of government which seems to be cracking under the strains imposed upon it by an affluent and divided society.