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The Honest Citizen's Guide To Revenue Sharing

By Henry Aaron

And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right
And all were in the wrong!

Moral:
So oft in theologic wars,
The disputants, I ween,
Rail on in utter ignorance
Of what each other mean
And prate about an Elephant
Not one of them has seen!

from John Godfrey Saxe,
"The Blind Men and the Elephant"[1]

It is eight months since President Nixon made his second call for general revenue sharing. The debate about the Administration plan has been vigorous, but confusing. The diversity of the asserted merits and demerits of the proposal arouses wonder that a single policy can do such varied good and harm. Participants in the debate have advanced numerous reasons why revenue sharing will advance or retard particular objectives and they have developed some interesting data; unfortunately, the data seldom bear on the crucial issues in the debate.

The revenue sharing debate has been inconclusive for quite specific reasons. The first reason is that contradictory assumptions about the consequences of revenue sharing are implicit in the list of objectives it is supposed to advance. The second is that neither economists nor political scientists have answered the crucial economic and political questions about the consequences of revenue sharing. This situation is a common feature of debates on important political questions.

1. *Illustrated Treasury of Poetry for Children,* David Ross (ed.) (Grosset and Dunlap, 1970), p. 232.

Economic and political theory have made two major contributions to the debate on revenue sharing. The first contribution, made long ago in another context, is that differences in the *average* income among communities cause fiscal inequities.[2] In order to purchase equal levels of public services, citizens in the poorer community may have to pay higher taxes than citizens with the same income in the richer community. This situation arises because a given tax rate yields more revenue when applied to a large than when applied to a small pool of income, retail sales, or property values. Furthermore, if people decide where to live partly on the basis of local tax rates, the lower tax rates in the wealthier community will tend to attract new residents, particularly

2. James M. Buchanan, "Federalism and Fiscal Equity," *A. E. A. Readings in the Economics of Taxation,* edited by Richard A. Musgrave and Carl S. Shoup (Richard D. Irwin, 1959), pp. 93-109; Richard A. Musgrave, "Approaches to a Fiscal Theory of Political Federalism," and James A. Buchanan, "Comment," *Public Finances: Needs, Sources, and Utilization* (Princeton University Press, 1961), pp. 97-129.

This Issue in Brief

Proposals for Federal revenue sharing with the states have aroused lively debate but contradictory assumptions pro and con on the plan result only in confusion, says Dr. Aaron.

"We should not base our attitudes about revenue sharing on vaguely stated objectives which upon close examination are inconsistent with one another because they depend on opposite responses by state and local governments," he says.

After analyzing the contradictory claims and assumptions, he offers an alternative procedure for achieving the goal of fiscal equalization among the states.

high income families for whom taxes are important. These trends can be strengthened by zoning or other policies designed to repel the poor and attract the rich and by the presence in poor communities of more problems—crime, fires, trash, hard-to-educate children—which generate high public costs.

The foregoing propositions are simple but profoundly important:

1) equal tax rates buy fewer services in poor communities than in rich communities;

2) if residential location is influenced by tax rates, the rich will tend to congregate in wealthy communities; and

3) these two effects are mutually reinforcing.

The corollary of this view is that, in the absence of such outside action as financial aid to governments of low income communities, fiscal forces will tend to increase economic disparities among communities. Those who deplore such disparities should favor aid to poor jurisdictions.

The second major theoretical contribution shows that under certain conditions revenue sharing will cause a reduction in local taxes to citizens in the aided community and that the reduction to each taxpayer will be proportional to his tax burden.[3] In practice, of course, this effect might occur through a failure to enact tax increases which otherwise would have been imposed. In these circumstances, revenue sharing is the ideal instrument for correcting fiscal disparities *provided* that aid is so distributed that communities with relatively low incomes and bad problems receive most aid. In other words, the formula under which funds are distributed is absolutely crucial; a bad formula could increase rather than reduce fiscal disparities.

Unfortunately, the assumptions necessary to reach this rather powerful conclusion are strong and unrealistic. Specifically, the conclusion does not hold if there are "threshold effects." For example, if the community responds only when aid reaches a certain size, the size of this threshold may differ among otherwise identical communities in unpredictable ways. Similarly, such factors as whether a community is growing rapidly or stagnating or whether the community is proud or ashamed of its political legacy may cause otherwise identical communities to react differently to revenue sharing. When the impact of such diverse influences is taken into account, the conclusion that revenue sharing is equivalent to a proportional cut in municipal taxes no longer follows necessarily.

State Response to Aid Difficult to Predict

Given the typical inconclusiveness of theory in forecasting the consequences of revenue sharing, one turns to empirical efforts to measure the response of communities to outside fiscal aid. The results of such efforts are similarly inconclusive, partly because fiscal aids come with various kinds of conditions, political deals, and arm twisting and partly because the studies have tended to be somewhat mechanical statistical exercises rather than estimates of carefully designed models of government behavior.

The most recent and sophisticated effort to measure the impact of Federal grants on state and local government expenditures finds that state and local governments return only 10 percent of any revenue sharing grant to citizens through lower taxes.[4] Although such work offers some hope that eventually we may be able to measure accurately state and local responses to Federal aid, we cannot now predict with any confidence what the impact of unrestricted Federal aid to state and local governments will be on the tax and expenditure policies of either the Federal government or of state and local governments. The crippling effect of such ignorance on rational debate has been made clear by Stephen Dresch who has shown that the impact of revenue sharing on state and local governments depends acutely on which Federal taxes must be increased or which Federal expenditures must be cut is order to create enough fiscal elbow room for revenue sharing, and that the impact of revenue sharing on individuals depends acutely on how state and local governments respond to increased aid.[5]

The inability to predict confidently the response of Federal, state, or local governments expresses itself in implicitly contradictory assumptions about these responses which I shall explore in the remainder of this paper.

Among the more important objectives advocates have claimed revenue sharing will advance are:

3. David F. Bradford and Wallace E. Oates, "A Theoretical Approach to Revenue Sharing," *Quarterly Journal of Economics* (August 1971); and "Towards a Predictive Theory of Intergovernmental Grants," *American Economic Review*, Vol. 61 (May 1971), pp. 440-48.

4. Martin C. McGuire, "Federal-Local Interactions in the Allocation of Resources," (mimeo).

5. Stephen P. Dresch, "An Alternative View of the Nixon Revenue Sharing Program," National Bureau of Economic Research (September 30, 1970, processed).

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1) the transfer of decision-making power concerning public expenditures from the Federal government to state and local governments;

2) improvements in the ability of state and local governments to operate efficiently;

3) reduction in the degree to which state and local governments rely on regressive taxes—sales taxes and, particularly, property taxes;

4) removal of fiscal mismatch between over-burdened state and local governments and the perennially overfinanced Federal government;

5) equalization of the fiscal burden citizens in various states and localities must bear to provide equivalent services;

6) preservation of the size of the public sector by diverting excess Federal revenues from possible tax cuts into expenditures by state and local governments.

This list is not exhaustive, but it is sufficient for purposes of illustration. The first objective of revenue sharing—to transfer decision-making power over public expenditures to state and local government will not be achieved if state and local governments allow revenue sharing to substitute significantly for local taxes. The theoretical model described above suggests that they will do so; the empirical study cited above suggests that they will not. If they cut taxes or delay tax increases, state and local governments will be unable to perform additional functions. In addition, this argument for revenue sharing suggests that at least some part of shared revenue should be diverted from categorical aids through which the Federal government now induces state and local governments to act as the Federal government's agent, since categorical aids vest some of the authority about how funds should be spent in the Federal government. The goal of decentralizing political power will be partly frustrated if states reduce current assistance to local governments by all or part of the shared revenues they are required to "pass through" to local governments. In that case, power would be decentralized less than the intent of the administration's revenue sharing proposals.

The goal of enabling state and local governments to operate more efficiently is rather vague. For those who allege that the proliferation and complexity of present categorical grants cause inefficiency, the cure must lie in grant consolidation and simplification or in the replacement of present categorical grants by revenue sharing. For those who regard revenue sharing as an overhead grant which will help state and local governments to use categorical aid more efficiently, revenue sharing should not replace existing categorical aids. In either case, to the extent that shared revenues replace state or local tax effort, the efficiency enhancing power of revenue sharing is eroded. Similarly, if states elect to offset aid to localities by curtailing other general aid, cities, counties, and school districts will not experience the efficiency enhancing effects revenue sharing is supposed to produce.

Those who hope revenue sharing will reduce reliance on regressive sales and property taxes must base their hopes on several assumptions. Unlike those who wish to help state and local governments make more decisions and to make them more efficiently, tax reform advocates must hope that shared revenues supplant state and local taxes. Moreover, they must be confident that state and local governments will curtail growth in the relatively sluggish sales and property taxes rather than in the elastic and progressive income tax.[6] Moreover, if a freeze or rollback in the property tax is the main goal, they must hope that states pass through to local governments not only the mandated share, but also the states' own share as well. They must feel confident that revenue sharing will not reduce other grant assistance, will not curtail other progressively distributed Federal assistance, or substitute for progressively distributed Federal expenditures. If these conditions are not met, revenue sharing may well reduce the overall progressivity of the tax system.

Argument Doesn't Agree with Facts

Most proponents of revenue sharing have alleged that a serious fiscal mismatch exists. By historical and political accident, the Federal government has taxes that grow faster than the problems we wish to solve nationally, while the reverse is true at the state and local level. As the often repeated slogan goes, the Federal government has the best taxes while the state and local governments face the worst problems. The vitality of this argument in the face of facts that flatly contradict it suggests that a nicely rounded phrase is indestructible.[7] But even if this argument were supported by the facts, it presumes that shared revenues will flow to those jurisdictions most weighted down by problems. Since neither the state allocation nor the pass through formulas in the Administration's proposal take need into account, this argument must presume that state governments will adjust other forms of aid so that shared revenues, are concentrated on needy communities. Furthermore, this argument presumes that shared revenues will not replace other grants and that the Federal government will not delegate to the states functions formerly fulfilled at the national level. If revenue sharing results in higher Federal expenditures and taxation than would otherwise occur, then the greater Federal tax effort will probably impair the ability of state and local govern-

6. In addition, they must feel confident that recent theoretical work by Peter Mieszkowski, "The Property Tax: An Excise Tax or a Profits Tax" (mimeo), is incorrect. Mieszkowski argues forcefully that the property tax should be regarded predominantly as a wealth tax, with excise side-effects. Viewed in this light, the property tax, far from being regressive, is one of the most progressive taxes now administered in the United States.

7. See Charles Schultze, *et al.*, *Setting National Priorities: The 1972 Budget* (The Brookings Institute, 1971), p. 142; Richard A. Musgrave and A. Mitchell Polinsky, "Revenue Sharing: A Critical View," *Harvard Journal on Legislation*, Vol. 8 (January 1971).

ments to raise taxes. In any case the alleged fiscal mismatch will not be reduced if state and local governments allow shared revenues to replace revenues from their own sources or if funds leak out to jurisdictions in comfortable financial circumstances.

Revenue sharing receives much support from those who see a fiscal imbalance among the states. Revenue sharing will reduce such imbalance, more or less, depending on the particular formula for allocating aid. This objective will be achieved regardless of state or local actions. Revenue sharing will tend to reduce the differences in tax effort citizens of different jurisdictions must make in order to buy equivalent public services. Whether they use shared revenues to cut taxes (or to defer increases) or to improve local public services is a matter of local choice. The point is that the costs of various levels of public services, in terms of tax rates will be equalized. Federal actions, however, could defeat or reinforce this effect of revenue sharing. Should revenue sharing lead to cuts in other grants-in-aid which equalized fiscal burdens, the net equalizing effect would be reduced and perhaps erased.

Lack Good Formulas For Equalization

For equalization purposes, revenue sharing should be tied entirely to measures of disparity in fiscal capacity. Despite efforts to construct complex indices, the best guides to the presence of fiscal strengths and weaknesses remain measures of income, wealth or the incidence of poverty. Even such formulas do not assure equalization of fiscal burdens among cities, since state legislatures might offset equalizing effects by altering other state aid formulas.

The argument that revenue sharing will help maintain the size of the public sector presumes that state and local governments will not reduce taxes or delay tax increases as a result of external aid. It presumes also that the Federal government will not curtail other forms of assistance to make room for revenue sharing. In fact, it assumes that all other Federal government expenditures taken together will be roughly as large with revenue sharing as they would have been without it.

Conclusion. The foregoing survey of the motives for revenue sharing indicates that advocates have made arguments that presume:

1) that state and local governments will and that they will not cut taxes (or postpone tax increases) as a result of revenue sharing,

2) that the Federal government will and that it will not reduce categorical grants-in-aid if it provides revenue sharing,

3) that we have some idea of what Federal taxes will be raised or expenditures will be cut to finance revenue sharing so that we can appraise the full effects of revenue sharing, and

4) that states will pass through to local governments exactly the legally stipulated portion of shared revenues, that share plus the state's share, or differing proportions according to the magnitude of the problems facing each jurisdiction.

The contradictory assumptions regarding the behavior of Federal, state, and local officials in response to revenue sharing may explain the peculiar cross currents in the support for revenue sharing. The contradictory responses to revenue sharing which advocates implicitly assume are like the many aspects of the elephant no one of them has seen.

None of the foregoing is meant to suggest that action to strengthen the federal system should wait until we know exactly how revenue sharing will affect political decisions at all levels. It does suggest that we should not base our attitudes about revenue sharing on vaguely stated objectives which upon close examination are inconsistent with one another because they depend on opposite responses by state and local governments. Support should be based rather on the one national objective that the Federal government has exclusive power to achieve—fiscal equalization among states; fiscal equalization among cities cannot be imposed if states wish to frustrate it without much larger outlays or more arm twisting than presently contemplated.

Viewed in this light, the Administration's revenue sharing proposal is poorly designed. The correlation between per capita benefits and per capita income is low. A superior procedure would link shared revenues to the presence within a jurisdiction of families and individuals judged too poor to support themselves and to contribute enough through taxes to support a pro rata share of public services. For example, a grant could be made on behalf of all recipients under the Family Assistance Plan to the governmental jurisdictions within which the recipient resides. The grant could be a flat amount per capita or it could be based on the level of assistance received by individuals. It could be apportioned on the basis of the level of public services each jurisdiction supplies.

I do not wish to make excessive claims for this formula for distributing aid. Revenue sharing apportioned on the basis of low income population would equalize fiscal burdens among states more effectively than the Administration plan. However, it would require higher Federal taxes or lower Federal outlays for other purposes. It would channel more funds to cities than the Administration's proposals. But it would direct, perhaps, excessive aid to the South. Whether or not one chooses to support revenue sharing might well depend on whether one regarded it as competitive with the nearly $8 billion per year cut in business taxes provided this year, or with welfare reform and liberalization. Furthermore, although revenue sharing can be designed to reduce fiscal imbalances among states and localities, we have no idea whether it will reduce or aggravate income inequality among individuals.