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90th Congress 1st Session } JOINT COMMITTEE PRINT

REVENUE SHARING AND ITS ALTERNATIVES: WHAT FUTURE FOR FISCAL FEDERALISM?

PREPARED FOR THE

SUBCOMMITTEE ON FISCAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

Volume II:

RANGE OF ALTERNATIVES FOR FISCAL FEDERALISM

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Part 1

THE RANGE OF ALTERNATIVES

FEDERAL AID TO STATE AND LOCAL GOVERNMENTS: THE POLICY ALTERNATIVES

BY MURRAY L. WEIDENBAUM*

INTRODUCTION

This study of the policy mix of Federal aid to State and local governments attempts to achieve two objectives: (1) to examine the case for increased Federal financial assistance to State governments and their subdivisions and (2) to analyze as objectively as possible the major alternative ways of distributing the aid.

The size and composition of Federal aid to State and local governments in the coming years will be strongly influenced by two interrelated factors: (1) the public policies adopted to utilize the resources made available by a post-Vietnam military cutback; and (2) the growing public awareness of the "fiscal mismatch" between Federal financial resources and State and local governmental program responsibilities.

These two factors are closely related because Federal programs designed to reduce the fiscal mismatch also represent possible alternative ways of offsetting the deflationary impacts of a reduction in military spending.

NATURE OF A LIKELY POST-VIETNAM ENVIRONMENT

At this point in time, it is extremely difficult to speculate as to the precise nature of a cutback in U.S. defense spending following peace in Vietnam. If the general dimensions correspond to the Korean experience, it would be expected that spending would decline substantially after the cessation of hostilities, but not down to the level prior to the conflict. As Vietnam outlays are now running at over $20 billion a year, a reduction of about $15 billion in U.S. military demand might be anticipated during the 12- to 24-month period following the cessation of hostilities. The new level of military spending would still be in excess of $50 billion a year and continue to require a substantial industrial base to support it.

The replacement of the $15 billion of military demand would represent the basic task of post-Vietnam economic adjustment. The major alternatives that can and are being considered in the Federal Government's current exploratory planning were listed in the January 1967 Economic Report of the President.[1] The general types of actions are

*Washington University. The author wishes to express his appreciation to Stephen F. Seninger who served as his research assistant.

[1] *Economic Report of the President, January 1967*, p. 24.

(1) tax reduction, (2) adjustment of monetary and financial policies, (3) expansion of Government spending programs, and (4) Federal financial support to State and local governments.

The specific and essentially short-term question of the economic adjustments to the cessation of hostilities in Vietnam also involves many longer run and perhaps more fundamental considerations of social, political, and economic policy, of which aid to State and local governments is just a part. For example, there are various methods of reducing taxes and thereby pumping additional purchasing power into the economy. Prior to the Vietnam buildup there had been some public discussion of focusing the next round of tax adjustments on the lower income brackets. Such action would be more than a short term policy to offset the deflationary impact of the military cutback. It could also have an important influence on income redistribution. It also would constitute a decision to emphasize consumption at the expense of investment insofar as the lower income groups spend an above average share of their income for current consumption items and save proportionately less.

Important policy choices will be made both within as well as between the major categories of post-Vietnam economic adjustment actions. The choice between tax reduction and Government expenditure increase is not likely to be an either/or one, but some combination of the two. Hence, the public sector is not likely to contract by the full amount of the military cutback (which would be the result of complete reliance on tax reduction) but some tendency in that direction would result from most of the likely combinations of tax reduction and Government spending increases.

Limiting the short-term post-Vietnam adjustment efforts either to expansion in direct Federal operations or to general tax reductions would lessen the ability of the Federal Government to embark on the block grant or similar long-term efforts which have been proposed to aid State and local governments in their fiscal problems. However, the availability of such "discretionary" revenues of the Federal Government may become a long-term phenomenon.

THE FISCAL MISMATCH

For a considerable period of time, students of public finance have been impressed by the tendency of Federal Government revenues from existing tax rates (during a cold war period) to rise faster than the gross national product or even then the expenditure requirements for existing programs.[2] This situation comes about essentially because of two factors.

The first is the primary reliance by the Federal Government on an income tax with a generally progressive rate structure. As a result, Federal revenues tend to increase along with the Nation's economic growth, but at a more rapid rate.[3] The second factor is the dominance of Federal spending by military programs. Hence, during periods of

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[2] Cf. Gerhard Colm and Manuel Helzner, "Financial Needs and Resources Over the Next Decade: At All Levels of Government," in National Bureau of Economic Research, *Public Finances: Needs, Sources, and Utilization*, Princeton, Princeton University Press, 1961, pp. 3–21.

[3] Cf. Otto Eckstein, *Trends in Public Expenditures in the Next Decade*, New York, Committee for Economic Development, 1959, p. 46.

peacetime or even cold war, when defense spending is relatively stable, total expenditures for existing Federal Government programs do not tend to rise as fast as the yield of the progressive tax structure (even though individual civilian programs may be growing at a rapid rate). Table 1 contains an estimate of the magnitude of the "potential" excess of revenues from existing rates over expenditure requirements of currently authorized programs.

TABLE 1.—*Projections of the gross national product and the Federal budget*

[Fiscal years; in billions of dollars]

Category	1955	1965	1975 projected
GNP (projected at 3¾ percent real annual growth rate)	378.6	648.7	990.3
Federal revenues (projected at present rate structure)	67.8	119.7	202.7
Revenues as percent of GNP	17.9	18.5	20.5
Federal expenditures (projected for current programs and cold war)	70.5	122.4	172.0
Expenditures as percent of GNP	18.6	18.9	17.4

Source: M. L. Weidenbaum, *Prospects for Reallocating Public Resources* (forthcoming).

Most examinations of State and local government budgets reveal a relationship between revenues and expenditures which is fundamentally different than the Federal one. The bulk of State and local revenues is obtained from regressive or proportional taxes (primarily on property and retail sales) which are generally estimated to yield revenue increases at rates equal to or less than the growth in GNP.[4]

In contrast, the requirements for existing State and local expenditure programs, notably education and welfare, tend to rise more rapidly than either the revenues from existing tax rates or the GNP.[5] For example, the Advisory Commission on Intergovernmental Relations has pointed out that in recent years State and local spending has been rising at the rate of 8–9 percent a year, strikingly faster than the growth in the GNP. The Commission believes that the recent rate of increase in expenditures of State and local governments can be expected to persist, at least for some years, because the forces that produced it continue to be operative and additional ones are developing.[6]

Hence, the fiscal outlook for State and local governments tends to be one of "potential" deficits—on the basis of existing tax rates and expenditure programs. In practice, of course, the actual Federal surpluses are "used up" and the actual State and local deficits are narrowed.

Under these conditions, the Federal Government is continually expanding civilian programs, adding new ones, and occasionally reducing tax rates, as the revenue growth permits. Hence, the projected "ex ante" gap between Federal revenues computed on the basis of

[4] A comprehensive tabulation of the elasticities of major categories of State general revenue is contained in Advisory Commission on Intergovernmental Relations, *Federal-State Coordination of Personal Income Taxes*, October 1965, p. 42.

[5] Cf. Joseph A. Pechman, "Financing State and Local Government," in American Bankers Association, *Proceedings of a Symposium on Federal Taxation*, New York, 1965, p. 76; Selma J. Mushkin and Robert F. Adams, "Emerging Patterns of Federalism," *National Tax Journal*, September 1966, pp. 236–240. For a contrary view, see Elsie M. Watters, *Fiscal Outlook for State and Local Government to 1975*, New York, Tax Foundation, Inc., 1966, 128 pp.

[6] Advisory Commission on Intergovernmental Relations, *op. cit.*, p. 3.

existing tax laws and Federal expenditures estimated on the basis of continuation of current programs mainly signifies the amount of discretion that may be exercised by policymakers in the future. On an "ex post" basis, past experience indicates that it is most unlikely that an entire decade will go by without important changes in either tax legislation or governmental program authorizations.

Moreover, recent economic analysis has pointed out the adverse effects of a large potential surplus in the Government budget under certain conditions. Such potential net inflow to the Federal Government may be self-defeating if it exercises a depressive influence on the level of economic activity, thus reducing governmental revenues from their potential, and preventing the realization of a large actual budget surplus.[7]

The actual responses of State and local governments to their potential deficit positions customarily take a variety of forms. They are almost continually raising tax rates, utilizing new tax sources, raising property assessment ratios, deferring desirable programs, and taking similar actions to stay within the limits of their income and of their authorized debt structures.

Each of the existing sources of funds will continue to be utilized to the extent that they can be, but some of them have severe restrictions. Further increases in debt are often limited or prevented by constitutional debt ceilings and similar legal restraints. The imposition of new taxes and raising the rates on existing sources appear to encounter increasing voter resistance and accentuate problems of interstate competition.

It seems clear that Federal aid in the form of specific grants-in-aid to States or their subdivisions will continue to expand. However, it is unlikely that existing Federal grant programs will increase sufficiently to enable State and local governments to bridge the gap between revenues from existing taxes and the rising expenditure requirements of established functions.

Hence, one basic assumption underlies the subsequent analysis: the Nation will begin to solve its long-term governmental budget problems if it links its actions on the potential Federal surpluses with the anticipated deficits in State and local budgets.

In the absence of a national decision to embark upon a major new effort of Federal aid to the States in the post-Vietnam period, there may be considerable possibility of not obtaining anything close to an optimum allocation of public resources in the United States. The possibility certainly exists that the Nation may use up potential increases in national revenues for "worthwhile" but relatively lower priority Federal programs, while State and local governments are forced either to defer relatively more worthwhile projects for lack of funds or to increase taxes which have adverse effects on economic stability and growth or on distributional equity. Hence, simply reacting to specific program demands, as the savings from peace in Vietnam are realized, may result in losing an important opportunity for reallocating public resources; a deliberate decision to use Federal funds

[7] Cf. Michael Levy, *Fiscal Policy, Cycles and Growth,* New York, National Industrial Conference Board, 1963, 141 pp.

to strengthen State and local governments may succeed in raising the aggregate level of public services or avoiding or reducing the need to expand the overall level of taxation.[8]

Federal Aid to the States

The general concept of distributing available Federal funds to the States goes back to early American history. In his second inaugural address, President Thomas Jefferson suggested a general program of Federal aid to the States, to be used for such purposes as "rivers, canals, roads, arts, manufactures, education, and other great objects within each States." [9]

Because of constitutional objections, President James Madison vetoed legislation which would have distributed to the States the dividends on the Federal subscription to the second national bank. Finally, in 1837 the Congress did vote to distribute surplus funds on an approximately per capita basis. The $37 million so allocated was more than double the annual Federal budget in those days. Some States used the 1837 distribution to capitalize the State banks; others devoted the money to local debt repayment or public works construction. Apparently, the greater part was devoted to education.[10] Considerable interest in distribution of Federal funds to the States arose again in the 1880's but did not result in any congressional action.

"Tied" or program grants to the States date back to the original land grants for higher education in Ohio in 1803.[11] In more recent years,[12] highways and welfare, along with education, have come to represent the bulk of Federal grants-in-aid.

Numerous other proposals have been made for Federal aid to the States. The Eisenhower administration attempted to shift a few Federal tax sources to State governments. That proposal was not adopted, in part, because it was linked with a shift of some program expenditures to the States. The proposal offered the enticement that the revenues to be shifted were to exceed the expenditures shifted.

More recently the Heller-Pechman plan [13] for relatively unrestricted block grants to the States has received considerable public attention and numerous variations have been introduced in the Congress. The Advisory Commission on Intergovernmental Relations has recommended a credit toward the Federal personal income tax be given for a portion of State and local income taxes paid.

Other "tax sharing" proposals have been made.[14] Some would give

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[8] An earlier version of this argument appears in M. L. Weidenbaum, "Federal Resources and Urban Needs," in Samuel B. Warner, editor, *Planning for a Nation of Cities*, Cambridge, MIT Press, 1966. pp. 61–78.

[9] For historical details, see Edward G. Bourne, *The History of the Surplus Revenue of 1837*, New York, G. P. Putnam's Sons, 1885.

[10] Chester W. Wright, *Economic History of the United States*, second edition, New York, McGraw-Hill, 1949, pp. 401–402; Bray Hammond, *Banks and Politics in America, From the Revolution to the Civil War*. Princeton, Princeton University Press, 1957, p. 451.

[11] Paul B. Trescott, "Federal-State Financial Relations, 1790–1860," *Journal of Economic History*, September 1955, p. 236.

[12] "Federal Aid to State and Local Governments," *Special Analysis, Budget of the United States, Fiscal Year 1967*, Washington, U.S. Government Printing Office, 1966, p. 137.

[13] Pechman, *op. cit.*, pp. 80–84; Walter W. Heller, *New Dimensions of Political Economy*, New York, W. W. Norton & Co., 1967, pp. 139–155

[14] Maureen McBreen, *Federal Tax Sharing: Historical Development and Arguments for and Against Recent Proposals*, Washington, D.C., Library of Congress, Legislative Reference Service, Jan. 30, 1967, 42 pp.

each State a fixed percentage of the Federal taxes collected within its borders. Other would be more indirect. For example, it is reasoned that reductions in Federal tax rates would enable State and local governments to raise their taxes without increasing the aggregate tax burden of the average taxpayer. Others would lighten the burdens on State and local governments by greater Federal assumption of civilian public sector programs.

A great deal of descriptive and interpretive material has been developed about these plans and their public policy implications. This study attempts, rather, to set up some relatively objective and measurable criteria for comparison and then proceeds to evaluate the extent to which the various alternatives meet the criteria.

ALTERNATIVE METHODS OF FEDERAL AID

The alternatives examined are (1) shared revenues, (2) tax credits, (3) direct Federal operations, (4) program grants, (5) straight block grants, and (6) block grants with an equalization feature.

The criteria for evaluation are (1) income distribution: the extent to which funds are distributed in favor of the low-income States and regions of the United States, (2) resource allocation: the effect on allocation of Government funds among programs and levels of government, and (3) stabilization: the influence on stability of economic activity in the United States.[15]

Tax sharing.—A fixed portion of Federal personal income tax revenues would be distributed to the States on the basis of the State in which the taxes were paid. The State governments would be left free to determine the uses to which they wish to put the funds they receive. To some extent, tax sharing would give the States a vested interest in the current high rates of Federal income taxation.

The Federal Government historically has shared with the States revenues from certain relatively small tax sources. These include sharing internal revenue collections with the Virgin Islands, sharing customs receipts with Puerto Rico and the Virgin Islands, and sharing a variety of national resource-type receipts with the States in which these resources (land, wildlife, power) are located.[16]

Tax credits.—The Federal tax structure currently provides credits for two types of State taxes: a limited credit for State death taxes against Federal estate tax liabilities, and 90 percent credit against Federal payroll levies for similar payments into State unemployment compensation systems.

A tax credit, such as the 40 percent income tax credit recommended by the Advisory Commission on Intergovernmental Relations,[17] differs from tax sharing substantially. The collection and administration of the State income tax is left in the hands of the State governments. Hence, they would only benefit to the extent that the Federal credit enables them to institute or raise income taxes above the levels otherwise politically acceptable.

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[15] These criteria are very roughly modeled after the three branches of the fiscal department of what has come to be Richard Musgrave's not so imaginary state. Richard A. Musgrave, *The Theory of Public Finance*, New York, McGraw-Hill, 1959, pp. 3–27.

[16] "Federal Aid to State and Local Governments," *Special Analysis, Budget of the United States, Fiscal Year 1967*, Washington, U.S. Government Printing Office, 1966, pp. 138–143.

[17] Advisory Commission on Intergovernmental Relations, *op. cit.*, pp. 18–19.

Expansion of programs carried on at the Federal level.—Potential increases in Federal revenue, over and above those required for financing continuing programs, could be assigned to new or expanded domestic civilian operations which the Federal Government would carry on in each of the 50 States. Examples of such new programs of an interstate character could include the construction and operation of mass transportation or environmental control facilities.

This approach would result in the largest amount of direct Federal intervention in the economy of any of the policy alternatives examined here, since there would be no State or local government participation. To some extent, there would be State and local benefits, since facilities would be provided which otherwise might not be available or would have to be financed locally.

Federal grants limited to specific program areas.—The Federal Government could increase the volume and number of conditional or program grants to State and local governments. This type of Federal aid is limited to specific functions, such as hospital construction and interstate roadbuilding, where the Federal agency administering the program sets detailed standards for the approval of individual State and local projects.

This alternative would avoid direct Federal operation of the public activities to be financed. However, it would increase further the impact of Federal decisionmaking on State and local policies and practices. A number of studies have shown that Federal grants influence the allocation of the recipients' own funds.[18] This of course is hardly surprising. A 50–50 grant for public school construction, for example, would reduce the local price of a $2 million building to $1 million. Assuming some elasticity of demand in response to such a price reduction, the result is almost inevitable.

Most Federal grants are awarded directly to State government. However significant precedents exist for the National Government bypassing the States and dealing directly with localities. Examples of such grant programs include housing and urban renewal, Federal aid to airports, and aid to mass transportation systems. In the aggregate, $9.9 billion of Federal aid payments were made to the States in the fiscal year 1965, and $1.2 billion directly to local units.

Straight block grants.—Block grants have been widely utilized in other nations, notably Great Britain and Canada. The basic concept of block grants is one under which the Federal aid to the States would be completely unconditional. The most straightforward method of distribution would be on a straight per capita basis. One approach is to set up a permanent trust fund to distribute a fixed portion of the Federal income tax base among the States each year regardless of the level of program grants or the State of the Federal Budget.

Some observers maintain that, unlike the other suggested forms of Federal aid, block grants would go to the root of the fiscal dilemma plaguing State and local governments. This method would provide a revenue source that would grow rapidly as the national economy

[18] Governmental Affairs Institute. *Impact of Federal Grants-in-Aid on South Carolina*, A Report to the Commission on Intergovernmental Relations, Washington, 1954, pp. 1–4; McKinney and Company, *The Impact of Federal Grants-in-Aid in the State of Washington*, San Francisco, 1954, pp. 1–3.

expands and incomes rise. It would help free States from the compulsion to look over their shoulders at what adjacent States are doing to attract industry before undertaking their own spending programs. Also, long-term planning by States and localities would be facilitated since the regular flow of funds would eliminate the uncertainties which are characteristic of the annual appropriations process. A major criticism, however, is that block grants would divorce the responsibility for collecting taxes from decisions on their use.

Block grants with equalization.—Most of the block grant bills introduced in the Congress contain an equalization feature. The bill that has received perhaps the most attention was introduced by Senator Jacob K. Javits and cosponsored by Senators Hartke, Scott, and Mundt.[19] It provides for establishing a trust fund in which an amount equal to 1 percent of total taxable personal income would be deposited into the Treasury each year. Under present conditions, this would amount to $2½ to $3 billion a year and would increase as the tax base expands. In effect a major portion of the growth in Federal revenues would be disbursed to the States; the absolute amount of revenue available for direct Federal operations would continue to grow, but at a slower rate than otherwise. The Javits plan is somewhat more restrictive than the original block grant concept, however, as the funds could only be used in the broad categories of health, education, and welfare.

Payments from the trust fund would be made under the following formula: (1) 80 percent would be distributed on the basis of population; this amount would be increased or decreased depending on the State's own tax effort, which would be measured by the ratio of the total revenues derived by the State to total personal income of the State's residents, as compared with the national average, and (2) 20 percent of the fund would be paid each fiscal year to the 13 States with the lowest per capita income; this would be distributed according to the population of the States involved.

The States, in turn, would be required to distribute an "equitable" portion of their allotments to local governments, which must be at least the average of the distribution of their own revenues to local governments over the previous 5 years.

COMPARISONS AMONG THE ALTERNATIVES

Effect on income distribution.—A major theme underlying many of the proposals for Federal aid to State and local governments is the desirability of reducing the inequality of incomes among the various States and regions of the United States. This would particularly enable the poorer areas to support a higher level of public services, more nearly approximating that of the Nation as a whole. The externalities often accompanying State and local government activities—benefits enjoyed by those outside of the taxing jurisdiction—are cited as a crucial reason for enabling the poorer States to provide a higher level of services than they could finance from their own resources.[20] Such externalities arise, for example, when persons reared and educated in one region move to and produce income in another.

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[19] *Congressional Record,* Oct. 11, 1965, pp. 25616–25617.

[20] George Break, *Intergovernmental Fiscal Relations in the United States,* Washington, The Brookings Institution, 1967, pp. 62–76.

Table 2 contains a summary analysis of the State shares of the six alternative aid proposals considered in this study. It is apparent that block grants with equalization would channel far more funds into the low-income areas than any of the other alternatives. It is also interesting to note that existing Federal program grants to State and local government are more income equalizing (in a geographic sense) than would be block grants distributed on a simple per capita basis. It also can be seen that direct Federal programs, as measured by the wages and salaries of civilian government employees, do not particularly favor low-income areas. As would be expected, tax credits and tax sharing provide the smallest amounts to low income States.

TABLE 2.—*State shares of Federal aid alternatives*

[Percent]

State grouping	Tax sharing	Tax [1] credits	Direct [2] Federal programs	Existing program grants	Per capita block grants	Block [3] grants with equalization
17 States with highest per capita incomes [4]	65.8	61.1	57.2	46.5	49.6	39.0
17 middle income States	19.9	23.2	23.2	24.7	25.2	20.2
17 States with lowest per capita incomes	14.4	15.7	19.3	28.8	25.0	40.6
Total	100.0	100.0	100.0	100.0	100.0	100.0

[1] Based on a credit for State income taxes equal to 7 percent of Federal individual income tax liability.
[2] Measured by the State-by-State distribution of Federal civilian wages and salaries.
[3] S. 2619, 89th Congress.
[4] 16 States and the District of Columbia.

NOTE.—Detail may not add to totals shown due to rounding.

Source: Appendix table 1.

This same rank order holds when the shares of the high income States are examined. They would receive the largest amounts under the tax sharing method, followed closely by tax credits and then by direct Federal programs. These States would obtain more funds from straight block grants than from the "status quo," as represented by their current shares of program grants-in-aid. These high-income States, of course, would receive the smallest proportions of a block grant program with a strong equalization feature.

Effect on major program areas.—It is the very nature of the block grant, tax credit, and tax sharing approaches that predictions cannot be made in advance as to how the funds will be distributed among the various program or functional areas. However, an exploratory effort is made here at just such a projection. It is based on one major assumption: that the States will follow the same pattern in distributing the Federal funds among the various program areas that they followed over the past decade in allocating revenue increases from their own sources.

That is, if a State's expenditures from its own revenues increased $2 million between 1955 and 1965, and its expenditures from its own funds on education rose $1 million, it is assumed that the State has a tendency or propensity to allocate 50 percent of new revenues to education. Precisely such "marginal propensities" were computed for each State for each of the major functional areas of State government expenditure.[21]

[21] This methodology is based with modifications upon James L. Plummer, "Federal-State Revenue Sharing," *Southern Economic Journal,* July 1966, pp. 122–124. The marginal propensities estimated here exclude expenditures from Federal grants-in-aid.

The crudeness of this effort is apparent when it is realized that the allocations among programs during the decade 1955–65 were strongly influenced by the matching provisions of various Federal grant programs which specified the minimum amounts that each State had to devote to a program from its own funds in order to receive the Federal funds. Also, there may have been considerable States effort to "catch up" in certain program areas, such as education, which would result in different "marginal propensities" in the coming decade.

Nevertheless, it is hoped that this analysis helps to convey the point that the selection of tax sharing or block grants or any of the other Federal aid alternatives may contain an implicit choice in emphasis in favor of education or health or highways or welfare, etc. because of the different State propensities to allocate funds among the various functions and the variation in individual State shares among the various alternatives. Table 3 contains the highlights of this analysis.

TABLE 3.—*Hypothetical utilization of Federal aid funds, based on State allocations of their own funds, 1955–65 (percentage distributions)*

FEDERAL AID ALTERNATIVE

Program area	Tax sharing	Tax credits	Per capita block grants	Block grants with equalization
Education	53.1	51.8	52.1	52.5
Public welfare	7.3	7.3	6.7	6.1
Highways	8.9	10.0	11.1	12.1
Health and hospitals	8.9	8.8	8.5	8.1
Natural resources	3.1	3.4	3.4	3.5
All other	18.7	18.7	18.2	17.8
Total	100.0	100.0	100.0	100.0

NOTE.—Detail may not add to totals shown due to rounding.

Source: Appendix table 2.

It can be seen that, under each of the four alternatives examined here, the States would allocate the bulk of their funds to education (between 52 and 53 percent). However, significant differences are noticeable in the case of other program areas. Given the assumptions made in this analysis, tax sharing and tax credits would result in larger shares of the funds going to "people-oriented" areas, such as welfare and health, than the block grant proposals (16 percent versus 14 to 15 percent), and less to the physical capital areas, such as highways and natural resources (12 to 13 percent versus 14 to 16 percent). To some extent, the investments in "human" capital may be more oriented to lower income classes than the highway and resource programs. Hence, the income equalizing characteristics—in a geographic sense—of the block grant approaches may be offset in part by the reverse tendency in an income-class sense.

Effect on local governments.—One of the major questions concerning the distribution of Federal funds without strings—via the tax sharing, tax credit, and block grant approaches—is the extent to which the States will "pass through" some of the funds to local government units. The concern on the part of the cities, which traditionally believe that they receive less than "fair" shares from the State legislatures, is evidenced by proposals that they have made for block grants directly

from the Federal Government, which would completely bypass the States.[22]

Some of the revenue sharing bills introduced in the Congress do have a "pass through" provision. Most of these would penalize States that give local governments a smaller share of the Federal funds than they receive of State money. Although some observers contend that this would mererly maintain past and current inequities, the supporters of block grants count heavily on reapportionment for redressing the balance.[23]

An analysis of the extent to which States share funds with their local governments was performed similar to that for major program areas, on the assumption that the States would share the new Federal funds with their subdivisions in the same proportions that they shared their own funds during 1955–65. No significant differences emerged among the various Federal aid plans. The States as a whole are estimated to share between 45 and 47½ percent of the funds with local subdivisions.

These calculations do not take account of any mandatory "pass through" provisions which may be contained in legislation enacting any of the aid alternatives. Hence, the figures merely illuminate the large extent to which the States have in the past shared funds with their local governments. Differences in the marginal "sharing" propensity were substantial among the various States.

Effect on economic stability.—Little if any attention has been given to the relationship of the alternative aid proposals to economic stability. Nevertheless, significant differences emerge from even the crudest analysis. Table 4 contains a ranking of the six alternatives, without any numerical values. Some explanations may be helpful.

TABLE 4.—*Stabilizing effectiveness of Federal aid alternatives*

Rank:	
1	Direct Federal programs.
2	Program grants.
3 to 4	Block grants. Block grants with equalization.
5 to 6	Tax credits. Tax sharing.

The major empirical study of the stabilizing effectiveness of Federal Government programs was made by the staff of the Bureau of the Budget in the middle 1950's.[24] The study showed the variety of expenditure programs that would increase with declines in the gross national product (and presumably vice versa). For example, unemployment insurance, old-age and survivors insurance, and related trust fund payments would be expected to increase because of the greater number of persons who would become eligible and who would apply for benefits under existing laws.

More veterans would be expected to apply for education benefits or to qualify for compensation and pensions, which are determined in part by their income.[25] It was estimated that total veterans expendi-

[22] A recent example is City of University City, Mo., *Proposed Tax Sharing Plan for All U.S. Cities Over 50,000 Population,* March 1967 (processed).

[23] Heller, *op. cit.*, pp. 159–161.

[24] Samuel M. Cohn, "The Stabilizing Effectiveness of Budget Flexibility: Comment," in National Bureau of Economic Research, *Policies to Combat Depression,* Princeton, Princeton University Press, 1956, pp. 90–100.

[25] Supplemental appropriations might be required, but these have been virtually automatic under such circumstances, in view of the strong moral and legal commitment of the government.

tures in 1955 would rise from $5.1 to $6 billion, a 17.6-percent increase, under the recessionary conditions postulated in the study. Also, the rising benefit levels would increase the workload of and demand for governmental administrative employees.

The findings on the stabilizing effectiveness of grants-in-aid were less clear. It was assumed that a relatively small ($100 million) increase would occur in public assistance grants as recessionary conditions increased the number of persons becoming eligible for the payments. Perhaps less certain was the belief that, to a small degree, some Federal grants to States would be reduced as the objectives could be achieved at lower cost on account of the price declines accompanying the recessionary conditions.[26]

An earlier analysis by James Maxwell seems to be generally consistent with the Budget Bureau study. He concluded that public assistance grants demonstrate "only slight built-in flexibility."[27] He reasoned that in prosperity a modest decline in number of recipients would be offset by larger average payments attributable to a rise in living costs during periods of prosperity. However, Maxwell stated that one may not safely conclude that the average public assistance payment is sensitive to a decline in prices during depression. "The historical trend toward higher welfare standards and the belief that subsistence payments should be maintained will operate against it."[28]

On the basis of the foregoing, table 4 has been prepared on the assumption that direct Federal operations do tend to be anticyclical; that is, that such Federal expenditures rise with declines in GNP, and that Federal program grants are also, on balance, anticyclical but not so markedly.

The differences in cyclical effects of block grants, tax credits, and tax sharing primarily arise from the different bases on which the amount of Federal funds to be disbursed would be determined. The block grant proposals generally have provided for allocating a percentage of personal taxable income to the States, while tax sharing provides for allocating a portion of personal income tax collections. Tax credits, of course, would provide a more indirect benefit to the States.

The various studies that have been made of the income elasticity of the Federal individual income tax conclude that it is substantially in excess of unity. Pechman estimated the elasticity at 1.6 percent between the fall of 1951 and the end of 1953.[29] Eckstein used an estimate of 1.4 percent for his projections.[30] Of course, these ratios underscore the stabilizing effectiveness of the Federal tax structure. However, a distribution of State aid funds keyed to fluctuations in Federal tax collections, which is the essence of the tax sharing proposal, would itself be destabilizing insofar as the funds available for distribution to the States would decline during recessionary conditions and rise rapidly during inflationary periods.

The studies of the variability of the tax base indicate greater

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[26] *Ibid.*, p. 98.
[27] James A. Maxwell, *Federal Grants and the Business Cycle*, New York, National Bureau of Economic Research, 1952, p. 38.
[28] *Ibid.*, p. 38.
[29] Joseph A. Pechman, "Yield of an Individual Income Tax During a Recession," in National Bureau of Economic Research, *Policies to Combat Depression*, Princeton, Princeton University Press, 1956, p. 124.
[30] Eckstein, *op. cit.*, p. 46.

stability, as would be expected for a progressive tax structure.[31] Hence, it would be expected that block grants—tied to the tax base—would be somewhat destabilizing, but not as much as tax sharing payments which are based directly on Federal revenue collections.

Although the cardinal (numerical) relations are subject to more conjecture, the ordinal or ranking relationships seem clear: existing Federal programs—both direct and grants-in-aid—on balance tend to demonstrate mild anticyclical characteristics. Block grants, either with or without equalization provisions, tend to contain mild destabilizing (procyclical) features. Tax sharing and indirectly tax credits tend to show up poorest in terms of effect on economic stability (see table 4).

Summary and Conclusion [32]

As might be expected, the foregoing analysis does not come up with a clear cut answer as to which single Federal aid approach is most desirable. Block grants with an equalization feature yield the greatest amount of income redistribution in favor of the low-income areas. However, tax credits and tax sharing, on the basis of the recent allocation patterns of State budgets, might tend to result in larger expenditures for welfare, health, and similar investments in human capital with an especial emphasis on the groups at the lowest end of the income class distribution. Yet, in terms of a stabilization objective, all of these proposals tend to show mildly destabilizing characteristics. In contrast, the existing programs, both direct Federal operations and program grants, seem to possess desirable anticyclical tendencies which would assist economic stabilization efforts.

Perhaps this analysis just provides a more objective basis for the essentially subjective and political task of decisionmaking. That is, if equalization of fiscal resources is the primary objective—a sort of fiscal federalism variation of the war on poverty—block grants with a strong equalization feature show up best.

If the concern, rather, is with emphasizing investments in human resources, tax sharing and program grant mechanisms both would rate highest. However, if the constraint is introduced that the new aid plan should have few if any controls over the State allocation of the funds, then the tax sharing approach would seem to be superior.

Hence, the choice among the various alternative means of channeling Federal aid to the States primarily becomes a matter not of examining the intrinsic merits of each alternative but rather of determining the relative emphasis to be placed on such basic objectives as income distribution, resource allocation, and economic stabilization.

Perhaps almost any of the alternative ways of strengthening State and local governments would be an acceptable "second best" solution. That is they might be superior, in terms of the overall needs of the Federal system, to merely devoting funds to new direct Federal programs or, worse still, to obsolescent programs firmly imbedded in the Federal Budget.

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[31] Heller prefers the tax base rather than the tax yield as the basis for block grants because "taxable income is somewhat more stable than revenues." Heller, *op. cit.*, p. 146. The ratio of the change in taxable income to the change in adjusted gross income on Federal personal income tax returns was estimated to vary between 0.59 and 0.62 during the period 1949–53. Leo Cohen, "An Empirical Measurement of the Built-In Flexibility of the Individual Income Tax," *American Economic Review*, May 1959, p. 535: Wilfred Lewis used the assumption of unit GNP elasticity of personal income in an illustrative ten-year projection of Federal receipts. Wilfred Lewis, Jr., "The Federal Sector in National Income Models," in National Bureau of Economic Research, *Models of Income Determination*, Princeton, Princeton University Press, 1964, p. 242.

[32] More detailed analyses are contained in a forthcoming study by the author, *Prospects for Reallocating Public Resources*.

APPENDIX TABLE 1.—*State shares of alternative methods of Federal aid*

[Percent of total Federal outlays for the purpose]

State	Tax sharing	Tax credits	Direct Federal programs	Existing program grants	Per capita block grants	Block grants with equalization
(1)	(2)	(3)	(4)	(5)	(6)	(7)
High-income group	(65.8)	(61.1)	(57.2)	(46.5)	(49.6)	(39.0)
Delaware	.9	.4	.2	.2	.2	.2
Nevada	.2	.2	(1)	.4	.2	.2
Connecticut	1.7	2.1	.6	.13	1.5	.9
New York	17.7	13.1	8.5	7.4	9.3	8.2
California	9.4	11.1	12.2	9.5	9.4	8.7
Illinois	7.9	7.6	4.0	4.5	5.5	3.6
New Jersey	3.1	4.5	2.6	2.0	3.5	2.3
Alaska	.1	.1	.8	1.0	.1	.1
Massachusetts	2.9	3.3	2.7	3.2	2.8	2.0
Maryland	2.3	2.7	12.7	2.6	2.2	1.5
Michigan	8.6	4.7	1.9	3.7	4.3	3.5
Washington	1.2	1.8	2.1	2.0	1.6	1.4
Ohio	6.0	5.9	4.3	4.3	5.3	3.6
Hawaii	.3	.3	1.0	.5	.4	.4
Colorado	1.2	1.0	1.6	1.4	1.0	.9
Missouri	2.3	2.3	2.0	2.5	2.3	1.5
Middle-income group	(19.9)	(23.2)	(23.2)	(24.7)	(25.2)	(20.2)
Oregon	.7	1.0	.9	1.6	1.0	.8
Pennsylvania	6.3	6.9	5.2	4.9	6.0	4.1
Wyoming	.1	.2	(1)	.6	.2	.2
Indiana	2.3	2.4	1.4	1.7	2.5	1.9
Rhode Island	.6	.5	.5	.6	.4	.3
Wisconsin	1.8	2.0	.8	1.6	2.2	2.0
Nebraska	.6	.7	.6	.9	.8	.6
Iowa	.8	1.3	.8	1.4	1.4	1.2
Minnesota	1.6	1.6	1.0	2.0	1.8	1.7
New Hampshire	.2	.3	(1)	.4	.3	.2
Kansas	.7	1.1	.9	1.2	1.2	1.0
Montana	.2	.3	(1)	.8	.4	.3
Arizona	.4	.6	.9	.9	.9	.8
Florida	1.6	2.1	2.2	2.6	3.0	2.6
Utah	.3	.4	.1	.8	.5	.5
North Dakota	.1	.2	.2	.7	.3	.4
Virginia	1.6	1.6	7.7	2.0	2.3	1.6
Low-income group	(14.4)	(15.7)	(19.3)	(28.8)	(25.0)	(40.6)
Texas	3.8	4.5	5.0	5.0	5.4	4.2
Vermont	.1	.1	(1)	.4	.2	.2
Maine	.2	.4	(1)	.6	.5	.4
Oklahoma	1.0	.9	.2	2.2	1.3	1.1
Idaho	(1)	.3	.3	.6	.3	.7
New Mexico	.2	.4	1.0	.9	.5	1.2
South Dakota	.1	.2	.4	.7	.4	.8
West Virginia	.4	.7	(1)	1.1	1.0	1.8
Georgia	1.3	1.3	2.4	2.5	2.2	4.3
North Carolina	2.4	1.2	1.2	2.0	2.5	4.8
Louisiana	.8	1.2	1.0	2.8	1.8	3.9
Kentucky	1.6	1.0	1.2	2.1	1.6	3.1
Tennessee	.9	1.2	1.6	2.2	2.0	3.8
Alabama	.6	1.0	2.7	2.0	1.8	3.4
South Carolina	.4	.5	1.0	1.0	1.3	2.5
Arkansas	.3	.4	.6	1.4	1.0	1.9
Mississippi	.3	.4	.7	1.3	1.2	2.5

NOTES TO APPENDIX TABLE 1

[1] Less than ½ of 1 percent.
Detail may not add to totals shown due to rounding.

SOURCE NOTES

Col. (1): States are arrayed in descending order of average per capita income during the years 1962–64. Figures for Maryland include the District of Columbia. Rankings are taken from Sophie R. Dales, "Federal Grants, 1964–65," Social Security Bulletin, June 1966, p. 12.

Col. (2): Based on Federal tax collections for 1964. "1964 Annual Report, Commissioner of Internal Revenue," Washington, U.S. Government Printing Office, 1965, p. 73.

Col. (3): Percentages are derived from estimates of a credit for State income taxes of 7 percent of Federal individual income tax liability in 1958, as computed in James A. Maxwell, "Tax Credits and Intergovernmental Fiscal Relations," Washington, Brookings Institution, 1962, pp. 184–185.

Col. (4): Wages and salaries of Federal civilian employees cover the calendar year 1963. Survey of Current Business, August 1964, pp. 18–21.

Col. (5): Actual distribution of Federal grants-in-aid to the States in the fiscal year 1964, "Annual Report of the Secretary of the Treasury on the State of the Finances for the Fiscal Year 1964," Washington, U.S. Government Printing Office, 1965.

Col. (6): Distribution based on State population figures for 1964. "Statistical Abstract of the United States, 1966," Washington, U.S. Government Printing Office, 1966, p. 11.

Col. (7): Estimates are for the Javits bill, S. 2619, 89th Cong. Congressional Record, Oct. 11, 1965, p. 25608.

APPENDIX TABLE 2.—*State incremental spending patterns: allocation of general expenditure increases among program areas, 1955–65*

[Percentage distribution]

States ranked by 1962–64 average per capita income	Education	Public welfare	Highways	Health and hospitals	Natural resources	All other	Total
Delaware	58.8	5.0	12.7	4.8	2.8	16.0	100.0
Nevada	47.0	4.2	17.5	3.9	0	27.2	100.0
Connecticut	34.1	9.3	24.4	3.9	2.3	26.0	100.0
New York	58.6	7.2	0	9.1	1.8	22.8	100.0
California	42.4	10.9	12.8	6.9	6.9	20.1	100.0
Illinois	47.6	13.1	8.7	15.4	2.4	12.7	100.0
New Jersey	50.2	9.6	0	11.1	6.0	22.9	100.0
Alaska [1]	41.9	5.7	6.2	3.8	0	42.1	100.0
Massachusetts	26.1	10.0	8.3	14.1	1.9	39.7	100.0
Maryland	44.0	5.1	7.2	14.2	1.7	27.7	100.0
Michigan	67.0	6.7	2.3	6.7	2.3	15.1	100.0
Washington	62.6	5.7	12.7	0	4.9	14.1	100.0
Ohio	56.0	11.5	0	9.4	2.5	20.5	100.0
Hawaii [1]	38.5	7.6	0	0	0	52.4	100.0
Colorado	57.4	4.1	9.3	13.0	4.0	12.2	100.0
Missouri	51.9	4.4	20.9	10.4	3.2	9.2	100.0
Oregon	53.9	5.6	14.4	5.8	5.4	14.9	100.0
Pennsylvania	52.7	7.0	14.8	9.8	2.3	13.5	100.0
Wyoming	61.0	1.8	18.6	7.1	10.4	0	100.0
Indiana	66.7	.8	12.7	6.7	2.1	10.9	100.0
Rhode Island	45.0	8.8	12.5	11.1	.7	21.8	100.0
Wisconsin	39.1	3.6	8.8	6.1	3.0	39.3	100.0
Nebraska	33.8	6.1	26.5	8.7	11.7	13.3	100.0
Iowa	40.5	6.2	28.1	8.2	2.9	13.9	100.0
Minnesota	59.7	3.4	13.1	8.4	3.4	12.1	100.0
New Hampshire	39.5	5.3	13.1	9.6	4.1	28.4	100.0
Kansas	55.7	4.4	12.1	12.1	6.2	9.5	100.0
Montana	63.7	0	16.6	2.8	4.0	12.8	100.0
Arizona	56.2	2.9	8.8	3.4	2.7	25.9	100.0
Florida	52.9	2.9	18.3	6.9	3.7	15.3	100.0
Utah	72.8	2.7	10.6	4.9	2.6	6.3	100.0
North Dakota	43.8	1.4	18.4	3.3	1.3	31.8	100.0
Virginia	45.6	2.0	19.4	11.8	4.1	17.1	100.0
Texas	65.9	3.3	13.4	5.4	1.3	10.7	100.0
Vermont	52.1	3.3	13.1	8.3	5.2	17.9	100.0
Maine	57.8	6.8	0	7.7	6.6	19.1	100.0
Oklahoma	41.5	13.2	19.0	6.1	4.1	16.0	100.0
Idaho	55.6	1.0	7.7	8.0	10.1	17.6	100.0
New Mexico	67.4	4.8	12.4	2.0	3.3	10.0	100.0
South Dakota	52.7	3.9	22.3	3.6	10.0	7.5	100.0
West Virginia	50.7	7.6	17.0	7.5	5.6	11.5	100.0
Georgia	59.6	5.2	8.7	6.7	5.5	14.3	100.0
North Carolina	59.9	1.6	8.7	7.7	3.0	19.1	100.0
Louisiana	48.4	4.8	17.2	8.4	2.7	18.5	100.0
Kentucky	49.4	2.9	19.4	8.0	2.7	17.7	100.0
Tennessee	51.1	.8	22.8	9.6	2.9	12.8	100.0
Alabama	52.5	7.7	20.2	6.9	2.3	10.3	100.0
South Carolina	38.1	.9	19.0	7.8	0	33.3	100.0
Arkansas	49.0	5.9	20.3	8.8	6.6	9.4	100.0
Mississippi	58.0	7.9	13.0	5.7	2.3	13.1	100.0

[1] Estimates were based on the period 1962–65.

NOTE.—Detail may not add to totals shown due to rounding.

Source: U.S. Department of Commerce, Bureau of the Census, "Compendium of State Government Finances" (Issues for 1955, 1962, and 1965).

THE POLICY SETTING: ANALYSIS OF MAJOR POST-VIETNAM FEDERAL AID POLICY ALTERNATIVES

BY RICHARD P. NATHAN*

The war in Vietnam has caused a pause in the allocation of Federal funds for civilian expenditure programs. It is important that we make use of this period to evaluate carefully the various Federal fiscal policy alternatives which could be adopted were there to be a settlement in Vietnam or a leveling off of defense expenditures in this area. Should this occur—with "fiscal drag" reemerging as a factor for economic planning purposes—there are several options available in the way of new fiscal policy directions.

One approach for reducing "fiscal drag" in the future is Federal tax reduction. The Revenue Act of 1964 (and to a lesser extent the Federal excise reductions of 1965) have shown that tax reduction can be an effective means of using a potential Federal surplus to stimulate faster economic growth in the *private* sector of the economy. The tax cut approach could be used again, either singly or in combination with other methods for devoting additional Federal funds to meeting priority *public* sector needs.

Within the *public* sector, there are a number of alternatives for reducing "fiscal drag" through increased public expenditures. A basic distinction must be made here between *direct* and *indirect* Federal spending. Direct Federal spending, for example, could be increased for foreign aid, civil defense, antimissile missiles, or for various directly financed Federal public works programs. Should it be determined, on the other hand, that newly available Federal revenues should be used indirectly within the public sector to aid State and local governments, there are several available policy options. This paper focuses on five major Federal aid policy alternatives which individually or in some combination could be a part of the Nation's post-Vietnam fiscal policy mix.

FIVE FEDERAL AID ALTERNATIVES

I. The most obvious alternative for increasing Federal aid to States and localities would be for the Federal Government to devote additional resources to priority public needs by expanding existing Federal-aid programs or creating new aid categories.

II and III. As opposed to heavier reliance on categorical Federal-aid instruments, two methods are currently under consideration for providing broader and less conditional Federal financial aid at the

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State level. One is the general aid or tax sharing approach.[1] The second is the adoption of a Federal tax credit for State taxes as a means of channeling additional Federal resources to the States.[2]

IV. A basic alternative to these two new forms of general financial aid—both of which go primarily to the *States*—would be to rely upon a new and broader form of Federal aid for *local* governments. Demands for greater funding under the 1966-enacted "demonstration cities" program must be evaluated in relation to the Heller-Pechman plan. Mayors and other city officials generally favor this or a related approach as opposed to the tax sharing or tax credit approaches for providing new and additional Federal aid to the States.

V. A fifth, although less likely, Federal-aid alternative is a major expansion of the concept of the Appalachia program enacted in March of 1965. This program provides financial assistance for a wide range of economic development purposes on a *regional* basis. This approach too has its strong supporters who believe that a shift to the broad regional concept is the most appropriate policy direction in the Federal-aid field.

I. Continued Reliance on Existing Types of Federal-Aid Programs

In evaluating any of the various proposals for major reliance on a new and broader form of Federal aid to States and/or localities, it is necessary to compare this approach with the existing Federal-aid "system" (if indeed it can be called a system). Thus, the policy option of increased reliance on the more traditional categorical-type Federal aids[3] is stressed and treated first in this paper. Although many readers may find it "old stuff" and may wish to skip over it, the next two sections review in quick fashion the historical development and major types of Federal-aid programs.

HISTORY OF FEDERAL AIDS

The earliest form of Federal aid to the States was basically unconditional. The Northwest Ordinance, predating even the Constitution, provided land grants to the States for education and internal improvements. These land grants had to be used for these two broad purposes, "but had no other conditions and almost no plan for supervision and control."[4]

Growing out of the land grant, the next major Federal aid development was likewise unconditional. Under the surplus distribution program of 1837 (under Andrew Jackson), the Federal Government dis-

[1] The term "tax sharing" is used here as synonymous with general aid as proposed in the Heller-Pechman plan and in subsequent legislative proposals. Some would use this term more broadly to include Federal tax credits for State and/or local taxes. It should be noted that tax sharing funds can also be channeled to local governments, either directly or by including a fixed minimum State-local pass through requirement in a tax sharing plan.

[2] See U.S. Advisory Commission on Intergovernmental Relations, *Federal-State Coordination of Personal Income Taxes*, October 1965.

[3] The term, "Federal aids," is used as a general term in this paper instead of the term, "grants-in-aid." The reason is that some Federal aid to States and localities is in the form of loans, guarantees, and payments in kind. The amounts under these aid forms are limited. The vast bulk of Federal aid to States and localities is in the form of cash payments, thus for most purposes the term grants-in-aid can be substituted for Federal aids in this paper.

[4] U.S. Commission on Intergovernmental Relations, *Final Report*, H. Doc. No. 198, 1955, p. 119.

tributed to each State a share of the Federal budget surplus in excess of $5 million, with each State's share being based on its representation in Congress.[5] Although no conditions were placed on the use of this aid, it was widely believed that Congress intended it to be used for education and internal improvements. (In this period education and internal improvements accounted for the vast majority of State expenditures.) The 1837 surplus distribution plan was short-lived. The first three quarterly payments were made, but because of the panic of 1837 subsequent payments were suspended.[6]

Jane Perry Clark in reference to these early and basically unconditional aid programs (land grants and surplus distributions) concluded that they were unsuccessful precisely because of their broad and basically unconditional character. "There was no suggestion as to how the States were to spend the money, and they squandered their patrimony, or at best sold it for what many people think was a mess of pottage." [7]

The year 1862 was a major turning point in the development of Federal aids. The first Morrill Act was enacted in that year defining the objectives of Federal land grants more precisely than had previous statutes and introducing new conditions and supervisory procedures.[8] The 1862 Morrill Act donated lands to the States specifically for land-grant colleges. The second Morrill Act, passed in 1890, provided cash payments annually to the States for the same purpose.

From the Civil War to the beginning of World War I, new Federal-aid programs came slowly. Most of the new programs were for agriculture and were categorical-type grants, e.g., agriculture experiment stations (1887), forest fire protection (1911), and agriculture extension work (1914). All three programs are still in existence. The 1911 forest fire protection program was significant because it introduced for the first time "Federal approval of State plans and continued Federal inspection activities" [9] which have remained to this day key features of most Federal grants-in-aid.

The World War I period was important in the history of Federal aid for two reasons—the Federal highway grant-in-aid system was established on a comprehensive basis under legislation enacted in 1916 and new categorical Federal grants-in-aid were initiated for various public health purposes and for vocational education.

In the decade following the war, although existing aids were continued and in some cases expanded, no major new Federal aids were enacted. Emphasis was placed instead on initiative and experimentation at the State level. During this period several States adopted pioneering social legislation that was later used as a basis for new Federal aid programs.

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[5] Daniel J. Elazar, *The American Partnership* (Chicago: The University of Chicago Press, 1962), pp. 200–210.

[6] In the 1840's a variation of the surplus distribution plan was reinstated, but like its predecessor ended soon afterward. See Elazar.

[7] Jane Perry Clark, *The Rise of a New Federalism* (New York: Columbia University Press, 1938), p. 140.

[8] See U.S. Commission on Intergovernmental Relations, ch. 5, for a useful summary history of Federal grant-in-aid policies and regulations, including a discussion of the structure and impact of the various land-grant programs.

[9] Clark, p. 142.

The Depression, like the Morrill Act of 1862, marked a major turning point in Federal aid policies.[10] It brought forth a virtual explosion of new Federal aids. This aid was generally provided on a basis which involved: (1) the precise definition of aided areas; (2) the requirement of State plans in conformance with Federal standards; (3) State matching of Federal funds; [11] and (4) the review and audit of aided programs by the relevant Federal officials. Among major examples of new categorical aid programs adopted during the Depression are:

—school lunch program (1933),
—old-age assistance (1935),
—aid to dependent children (1935),
—aid to the blind (1935),
—services for crippled children (1935),
—general health (1935),
—low-rent housing (1937).

The New Deal-initiated rise in the number and amount of Federal aid programs, although interrupted in the war years, continued in the postwar period under the Truman administration.

Coming into office in 1953, the Eisenhower administration sought to make basic changes in the scope and character of Federal-aid programs. Considerable emphasis was given to the work of various study and advisory groups set up in this field. The Eisenhower appointed Commission on Intergovernmental Relations (known by the name of its second Chairman, Meyer Kestnbaum) sponsored valuable research in this area and issue its own report in 1955. Later, in 1957 and 1958, an unsuccessful effort was made by the Eisenhower administration's Joint Federal-State Action Committee to eliminate certain Federal grants-in-aid in exchange for steps to turn over a compensating amount of Federal revenues to the States. The Action Committee recommended a specific tradeoff plan, whereby the Federal Government would turn over telephone excise tax revenues to the States in exchange for the elimination of Federal grants for vocational education and water pollution control. This proposal was adopted by the administration, but differences in Congress as to how these limited goals should be achieved, resulted in its ultimate rejection.

Despite the Eisenhower administration's interest in strengthening the States and simplifying intergovernmental fiscal relations, total Federal-aid increased to $7.3 billion in fiscal 1961, a threefold rise over the last year of the Truman administration. This increase is regarded by many as bipartisan validation of the New Deal extension of categorical Federal grants-in-aid into a wide range of traditionally exclusive State-local expenditure areas.

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[10] Historians differ on the degree to which the New Deal affected then existing Federal-State fiscal relationships. To some, the qualitative and quantitative impact of these new programs was so great as to basically alter the relationship between the Federal Government and the States. To others, such as Elazar, these new programs should be seen essentially as an extension of earlier Federal aid acitvities. While this paper does not go into an examination of this historical question, the view reflected here is that the New Deal programs, with the involvement of the Federal Government in so many areas of State-local activity, does constitute such a distinct break with the past as to cast doubt on Elazar's view that there has been a steady and relatively continuous development of "cooperative federalism" since the late 19th century.

[11] During the Depression some hard pressed States received loans for their matching share under various Federal aid programs. Some of these loans were later forgiven. See Clark, pp. 157–158.

The history of Federal aid under the Kennedy and Johnson administrations is well known. Major new programs have been established in the fields of education, antipoverty, manpower training, mass transportation, mental health, air and water pollution control, and aid to the arts. Expenditures under a number of existing Federal-aid programs have increased substantially. The next result has been a rise in Federal aid to States and localities from $7.3 billion in fiscal 1961 to over $17 billion in fiscal 1968. Furthermore, commitments made by the 89th Congress in 1965 on President Johnson's "Great Society" programs are expected to produce major increases in Federal-aid expenditures in future years—barring, of course, a reversal of present policies. Estimates vary as to the eventual cost of these commitments. Projections range from $18.5 billion in fiscal 1970 based simply on the fulfillment of existing legislative obligations to $22 billion with the assumption of "normal" growth in Federal-aid expenditures.[12]

In this quick history of Federal aids, programs have been treated as if they are substantially alike. The fact of the matter is that there are distinct differences in the finances, administration structure, and relative specificity of the various Federal-air programs now in effect. *For purposes of this report, it is useful to group Federal-aid porgrams under four broad types of Federal-aid instruments.* These four classifications described below are defined in terms of the financial basis on which Federal aid is provided and the way in which the federally aided area is defined.

TYPES OF EXISTING FEDERAL AIDS

In absolute dollar amount, the bulk of current Federal aid is paid to the States under grants-in-aid with Federal funds apportioned among the States according to a set formula. The various formula-type grants can be divided into three basic groupings, each of which is regarded here as a major type of Federal-aid instrument.

1. *Narrowly defined formula-type grants.*—The first grouping under formula-type grants is narrowly defined formula-type grants. It includes all Federal-aid programs which provide funds apportioned by formula for certain specific purposes within major functional expenditure areas. For example, until very recently there were a large number of narrowly defined Federal grant programs in the health area.[13] Likewise, under agriculture, Federal aid is provided for narrowly defined purposes such as experiment stations and extension services. Federal formula-type grants are also available for certain specific forestry purposes, for example, tree planting, insect protection, and fire prevention.

2. *Highways and public assistance.*—The second grouping under formula-type grants includes just the two very large programs under which Federal aid is provided in broad functional areas, but is subdivided under various headings within the aided areas. The two programs are highways and public assistance. Together they account for

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[12] Based on preliminary estimates provided by "Project 70," State-local finance project, Oct. 5, 1965. Prepared by Selma J. Mushkin and Robert Harris.

[13] Under a law passed in the 89th Congress, existing formula grants to the States for combating specific diseases were consolidated into "a flexible single grant to be awarded a matching basis to assist in meeting public health needs." *House Report No. 2271*, p. 2. This move to a block grant for public health is an important new development.

more than half of the Federal-aid funds budgeted for 1968. Under highways, Federal aid is provided for the construction of interstate, primary, secondary, and urban highways. In the case of public assistance, Federal aid is provided for the aged, blind, disabled, and for families with dependent children.

3. *Broadly defined formula-type grants.*—The third grouping of formula-type grants is of greatest interest in relation to new proposals for broader and less conditional Federal aid to State and local governments. Thus, a little more background is in order. This grouping includes those grants under which aid is given in major functional areas with relatively few conditions attached. Both of the illustrations under this heading are in the field of education—title I of the Elementary and Secondary Education Act of 1965 and the school aid for federally affected areas.

The purpose of title I of the Elementary and Secondary Education Act of 1965 ("Financial Assistance to Local Education Agencies for the Education of Children of Low-Income Families") is that of "broadening and strengthening public school programs in the schools where there are concentrations of educationally disadvantaged children." [14] It originally provides half of the average statewide cost of educating children from families with incomes of under $2,000 per year. Disbursements under title I in fiscal 1967 were approximately $1.2 billion. Compared to narrowly defined formula-type aids (above), this aid can be used flexibly for a wide range of new program purposes for the disadvantaged, except that it cannot be used for an across-the-board increase in teachers' salaries. This, of course, still falls short of the various education block-grant proposals under active consideration in the 90th Congress and as now proposed by the National Education Association.

School aid for federally affected areas has been provided since 1952 for school construction and current expenses in school districts where large Federal installations increase school costs or substantially reduce the local property tax base. This program has had a much longer history than title I and has retained its basically discretionary character over the years. Residence of the parent, Federal employment, and student entrollment are the three factors which determine eligibility. Beyond this, as long as the public school is approved by the State department of education, it qualifies to receive aid and can use these funds at its discretion.

There is one important respect in which the Federal Government has recently exercised control over local school districts under *both* title I of the 1965 act and the federally affected areas program, that is, the prohibition against the use of Federal-aid funds for racially segregated schools. This prohibition applies to *all* Federal aid. Thus, the role of the U.S. Office of Education in this respect can be treated as a somewhat special case. Aside from this requirement (albeit a substantial one), Federal aid funds provided under these two programs comes quite close to being discretionary aid for elementary and secondary education.[15]

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[14] U.S. Congress, *S. Rept. No. 146*, pp. 5–6.

[15] Now that a large, new aid for education programs has been enacted, the administration is attempting to reduce appropriations for federally affected areas. Congress has strongly resisted this effort.

4. *Project aid.*—In addition to these three groupings of formula-type Federal grants, there is an additional basic type of Federal aid—project grants. (Project aids can be further subdivided by type and purpose, e.g., demonstration, capital, program.) Project grants tend to predominate at the local level, whereas formula-type Federal aid in most cases is paid to the States. In recent years there has been a decided trend away from formula-type grants in favor of project grants. This applies both to revisions of existing programs and the adoption of new ones. While this trend may be beneficial in certain cases in terms of giving greater discretion and responsibility to the recipient jurisdiction, it has also meant that increasingly Federal-aid programs bypass the States.

To summarize, the four major types of aid instruments discussed here are listed below with key illustrations under each:

1. *Narrowly defined formula-type grants:*
   (*a*) Agricultural experiment stations and extension services.
   (*b*) Various forestry grants-in-aid.
   (*c*) National Defense Education Act (NDEA) title II (instructional equipment and materials) and title V (guidance, counseling, and testing).
   (*d*) Vocational rehabilitation.
2. *Highways and public assistance grants* (formula-type aid in broad functional areas, broken down into specific subcategories within the aided areas).
3. *Broadly defined formula-type grants:*
   (*a*) Title I of the Elementary and Secondary Education Act of 1965.
   (*b*) School aid for federally affected areas.
4. *Project aid:*
   (*a*) Urban renewal.
   (*b*) Public housing.
   (*c*) Open spaces.
   (*d*) Urban transportation.
   (*e*) Neighborhood Youth Corps.

THE PURPOSE OF FEDERAL AID

It can be seen from the above history and classification of Federal aids that beginning with the Civil War period the basic concept of most Federal-aid programs has been to *stimulate* as efficiently as possible the achievement of certain fairly narrow Federal objectives. This is clearly true in the case of narrowly defined formula-type grants, the highway and public assistance Federal-aid programs, and most project grant programs. This stimulative character of Federal aid was stressed in the 1955 Kestnbaum Commission Report.

> The grant's widest use has been in *stimulating* the States to launch or expand services for which State and local governments are generally regarded as primarily responsible. National funds and leadership have *stimulated* State and local activity in agricultural education and research, welfare services, public health

services, and vocational education, to cite some prominent examples. In some of these fields the States or localities had already made a start before the grant was made. Generally, though not always, the grants have produced notable spurts in State and local action, and the proportion of State and local expenditures to Federal aid has shown a steady and substantial overall increase.[16]

While there is agreement that categorical Federal aids stimulate States and localities to do things they would otherwise not have done, there is no such agreement as to whether this is a good thing. Here, it is useful to quickly review the theoretical underpinnings of current attitudes toward Federal aid and American federalism. One view of American federalism—the traditional or States' rights position—sees Federal-aid programs as tending to undermine the fundamental character of American federalism, in which there are two coordinate levels of government (National and State) each with its own assigned areas wherein it has basic responsibility or sovereignty.[17]

On the other side is an almost diametrically opposite school of thought. It views the achievement of national goals as more important than abstract political principles, like federalism.[18] The Federal Government, States and localities are seen as all working together, and there are therefore no limits as to the areas in which the Federal Government can provide financial aid to both States and localities.

The two proposed new Federal aid approaches discussed next in this paper (tax sharing and the tax credit) are relevant to this basic philosophic difference in attitude on American federalism and Federal aids in that they move in the direction of strengthening the States vis-a-vis the Federal Government. This is particularly true of the tax-sharing approach. It has been supported by Governors and others who favor a stronger role for State governments in American political life. By contrast, those with a more national orientation have tended to oppose this approach. This view was expressed sharply by Christopher Jencks in an article in the *New Republic*.

> The alternative to such idiocy (the Heller-Pechman plan) is to create, at long last, a national government which offers national solutions to the pressing domestic problems of the day.[19]

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[16] Commission on Intergovernmental Relations, p. 125. [Italic added.]

[17] The philosophical base of this position was expressed in the Kestnbaum Commission Report. In its definition of federalism (which Wayne Morse, a dissenting member of the Commission, likened to the "ultra conservative point of view"), the Commission urged that "we should seek to divide our civic responsibilities so that we . . . *reserve National action for residual participation where State and local governments are not fully adequate, and for continuing responsibilities that only the National Government can undertake.*"

For a current statement of the "conservative" view, the reader is referred to several essays appearing in *A Nation of States, Essays on the American Federal System*, edited by Robert A. Goldwin (Chicago: Rand McNally & Co., 1961). Essays to note are: "What the Framers Meant by Federalism," by Martin Diamond; "The Prospects for Territorial Democracy in America," by Russell Kirk; and "The Case for 'States' Rights,' " by James Jackson Kilpatrick. The reader might also be interested in an essay on federalism by Alfred de Grazia in *The Conservative Papers* (Garden City: Anchor Books, 1964), pp. 228–249. Finally, for a more theoretical statement of the conservative view, see Part I of *Federal Government* by K. C. Wheare (New York: Oxford University Press, 1964.)

[18] The concept of federalism implicit here was perhaps best expressed by the late Morton Grodzins of the University of Chicago. His definition of the Federal system likened it to a "marble cake, characterized by an inseparable mingling of differently colored ingredients, the colors appearing in vertical and diagonal strands and unexpected whirls." See: Morton Grodzins, "The Federal System," *Goals for Americans*, President's Commission on National Goals (New York: The American Assembly, 1960), pp. 265–282.

[19] Jencks, "Why Bail Out the States?" *New Republic*, Dec. 12, 1964, p. 10.

There is, however, a danger in overstating the philosophical significance of the differences between existing Federal aids and newly proposed broader aid approaches. There is presently underway something of a transformation of Federal-aid policies, deemphasizing the role of Federal grants as a means of stimulating the achievement of narrowly defined Federal objectives. A number of the new aid programs enacted under the Johnson administration provide aid in broad functional areas with considerable discretion to the recipient governmental jurisdiction. Title I of the Elementary and Secondary Education Act of 1965 is an obvious illustration. Likewise, community action project grants under title II-A of the Economic Opportunity Act of 1964 (although currently in disfavor in the Congress) can be used for a broad range of locally determined purposes. Comprehensive plans for a broad range of locally determined purposes. Comprehensive plans for the use of community action funds must be approved by the Office of Economic Opportunity; however, local officials have wide discretion as to the types of expenditures for which they can submit applications. And, as already noted, the creation of a new block grant in 1966 by consolidating the old public health Federal aid categories represents a significant internal reform of Federal-aid programs.

Over the last 2 years an effort has been made by the Johnson administration to give broad philosophical expression to these and other shifts in Federal-aid policies. The President in a speech in Ann Arbor, Mich., on May 22, 1964, called for "new concepts of cooperation, *a creative federalism*."[20] While the meaning of "creative federalism" has not yet been fully spelled out, it is said to involve: (1) closer and more cooperative relationships between Federal, State, and local management-level officials; (2) broader and more flexible Federal-aid programs; (3) more reliance on direct Federal-local relationships; and (4) an effort to work through new types of structures, such as areawide, regional, and public-private administrative units.[21]

The Heller-Pechman plan, the next Federal-aid approach to be discussed, goes much further than the various programs cited above as illustrations of "creative federalism." It did not specify any Federal-aid categories and it did not involve regulations or approval as to the actual expenditure of aid funds. Nevertheless, the above discussed recent Federal-aid policy developments must be taken into account in relating the tax sharing approach to the existing "system" of Federal aids for States and localities.

II. Tax Sharing

Walter Heller's recommendation to President Johnson in the spring of 1964 for supplementary general aid to the States gave the general aid approach greater public visibility than it has had at any

[20] Speech by President Lyndon B. Johnson, Ann Arbor, Mich., May 22, 1964, as cited in an article on "Creative Federalism," *Congressional Quarterly*, Apr. 22, 1966, p. 822.

[21] *Congressional Quarterly*, Apr. 22, 1966, pp. 822–823. See also: Max Ways, "Creative Federalism and the Great Society," *Fortune*, January 1966, pp. 120–123.

time in recent history.[22] As discussed by Heller, his original concept was aid to the States with no conditions attached other than those applying to *all* Federal spending, such as the various Constitutional protections and civil rights laws.[23]

THE HELLER-PECHMAN PLAN

The Pechman Task Force report to the President, submitted in the early fall of 1964, adhered basically to Heller's concept, although it apparently discussed a number of ways in which broad conditions could be placed on general aid. According to the press accounts, the task force recommended a plan to earmark a fixed percentage of the Federal income tax base to be set aside in a separate trust fund, the revenues of which would be allocated to States as general aid. (The tax base for these purposes was defined as the total taxable income of all Federal individual income taxpayers—approximately $250 billion in 1964.) Although no precise figure was endorsed, the Pechman Task Force is reported to have discussed a fund consisting of 1 percent of the Federal income tax base, which would have amounted to $2.5 billion in 1964 and an estimated $3.5 billion in 1970. This would have meant approximately $13 per capita in payments to the States in 1964.

The allocation system proposed by the task force was to divide the fund into two parts, the first part to be allocated to the States on a straight per capita basis, the remainder to be distributed among the lowest income States for equalization purposes. It was later estimated by Pechman in a speech before the American Bankers Association that—

> even if as little as 10 percent of the total were divided among the poorest third of the States (say, in proportion to population weighted by the reciprocal of per capita personal income), the grant to the poorest States would be almost double the amount it would obtain on a straight per capita basis.[24]

In addition to equalization, the task force apparently considered the inclusion of a tax effort factor. With this adjustment, States making an above average tax effort (measured in terms of State-local taxes relative to personal income) would receive a somewhat higher

[22] Sources of background information on the original Heller proposal and the Pechman Task Force report are:
(a) Edwin L. Dale, Jr., "Subsidizing the States," *New Republic*, Nov. 28, 1964, pp. 33–34.
(b) Robert L. Heilbroner, "The Share-the-Tax-Revenue Plan," *New York Times Magazine*, Dec. 27, 1964, p. 8.
(c) Richard J. Jannssen, "Sharing Revenues," *Wall Street Journal*, Nov. 17, 1964, p. 1.
(d) "Library of Congress Analyzes Tax Sharing," *Congressional Record*, Aug. 25, 1965, pp. A4791–A4793.
(e) Alan L. Otten and Charles B. Seib, "No-Strings Aid for the States?" *Reporter*, Jan. 18, 1965, p. 34.
(f) Tom Wicker, "The Heller Tax Plan," *New York Times*, July 27, 1965, p. 9.
(g) Richard C. Worshop, "Federal-State Revenue Sharing," *Editorial Research Reports*, Dec. 23, 1964, pp. 943–960.

[23] In an interview in June 1964, Heller suggested Federal aid "without Federal control" as one way to relieve "fiscal drag" in the future. *U.S. News & World Report*, June 29, 1964, p. 59.

[24] Joseph A. Pechman, "Financing State and Local Government," paper prepared for the Symposium on Federal Taxation of the American Bankers Association, Mar. 26, 1965, p. 18.

per capita allocation. States making a below average tax effort would be penalized.

A "pass-through" requirement for local governments has also been widely discussed in recent months. This feature is included in the Goodell bill (described below) and in other Republican and Democratic tax sharing bills introduced in the 90th Congress.

HISTORY OF THE PLAN

Since its inception in 1964, the Heller-Pechman plan has had an uneven history. At first, President Johnson appeared to be getting ready to endorse the plan. Toward the end of the 1964 presidential campaign, the White House issued a Presidential statement which said that "intensive study is now being given to methods of channeling Federal revenues to States and localities." [25] In addition to promising "intensive study" of specific plans, the President's statement took a strong position in principle on the sharing of growing Federal revenues with States and localities.

> The National Government, as a constructive partner in creative federalism, should help restore fiscal balance and strengthen State and local governments by making available for their use some part of our great and growing Federal tax revenues—over and above existing aids. [26]

On the day that the Presidential statement was issued (Oct. 28, 1964) the main outlines of the Pechman Task Force report appeared in a page 1 story in the *New York Times*. Thereafter, strong opposition arose from labor groups and Federal officials in the agencies which administer Federal-aid programs and who regard the Heller-Pechman plan as a threat to their long-run program objectives. With this build-up of opposition and apparently unhappy about the premature release of the Pechman Task Force report, the President called a halt to speculation about the plan in mid-December 1964. He indicated at a background press briefing that the plan would be set aside.

Despite the fact that leading State officials (including governors of both parties)[27] have continued to support the basic concept of

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[25] "Strengthening State-Local Government," Presidential Statement No. 6 on Economic Issues, Oct. 28, 1964, as reprinted in the *Congressional Record*, Aug. 25, 1965, p. A4816. Alan L. Otten and Charles B. Seib in an article in the *Reporter* said that this statement "was commonly interpreted as a Johnson endorsement of the Heller Plan."

[26] *Ibid.*

[27] Reporting from the Governors' Conference in Minneapolis, Tom Wicker said in the *New York Times*, "Virtually all the harried politicians who serve as Governors of American States liked the idea of the Heller Plan, but many have different ideas of what it is or ought to be." *New York Times*, July 27, 1965, p. 9. At their 1966 Interim Meeting at White Sulphur Springs, W. Va., the Governors again went on record favoring tax sharing. They said, in part:

Resolution No. 1:

"*Resolved*, That at the same time that we continue to work to modernize State and local governmental machinery, we believe it is essential that the Federal Government adopt new Federal intergovernmental fiscal policies which reflect a basic change in emphasis, giving more discretion and responsibility to State and local governments and moving away from the overreliance on national controls under the very large number of existing categorical Federal grant-in-aid programs; and be it further

"*Resolved*, That the National Governors' Conference specifically endorses the principle of tax sharing and the principle of block grants—consolidating existing Federal categorical grants-in-aid—to partially or wholly offset Federal categorical grant-in-aid programs which now exist or may be developed in the future."

Resolution No. 2:

"*Resolved*, That the National Governors' Conference authorize the Committee on State and Local Revenue to develop, in consultation with experts in the field and representatives of local governments, a Federal tax sharing plan for appropriate and timely consideration by the Executive Committee; be it further

"*Resolved*, That this plan include the allocation of additional revenue beyond present levels for use by the States and for distribution by the States to local governmental units."

Heller's proposal, the administration has maintained silence on the Heller-Pechman general aid plan since the end of 1964. There were however two exceptions. Prior to a dinner at the White House for Governors in March of 1965, "informed sources" in the administration indicated that the President would be "receptive" to a plea by the Governors for the plan.[28] More recently, general aid was discussed in the 1967 Economic Report of the President in relation to post-Vietnam fiscal policy planning activities.

REPUBLICAN SUPPORT FOR TAX SHARING

Strong pressure for the Heller-Pechman plan has also come from the Republican side. In July of 1965, the Republican Governors' Association and the Ripon Society issued a joint research paper strongly supporting the Heller-Pechman plan and lamenting the President's decision to set it aside.[29] Other Republicans in Congress have supported the plan. Senator Javits of New York, in September of 1965, proposed general aid to the States on the order of the Heller-Pechman plan, but specifically limited to health, education, and welfare purposes.[30] On the House side, Congressman Charles Goodell, chairman of the Republican Planning and Research Committee, proposed a tax sharing plan described briefly as follows:

> . . . the sharing of a fixed percentage of revenues from the individual Federal income tax with State and local governments for purposes which would be determined by the recipient governments.
>
> Beginning at 3 percent of the receipts of the tax ($1.8 billion), the amount shared would be increased in steps to 5 percent.
>
> Under this proposal 50 percent of the Federal grant would be allotted to the States for purposes determined by the States, 45 percent would be allotted to States for unconditional allotment to local governments, and 5 percent would be devoted to strengthening State administrative machinery and practices. Local government includes local educational agencies.

Altogether, 25 Republican Members of the House of Representatives introduced some form of tax sharing or general aid legislation in the 89th Congress. This number increased markedly in the 90th Congress (59 bills in the House and 29 Senate Republican sponsorships to date). In all likelihood, this increase was a response to 1966 election gains, which many Republicans interpreted as a widespread voter rejection of the Great Society approach to intergovernmental fiscal relations.

The new popularity of the tax-sharing idea in 1966 is demonstrated by the results of a December 1966 Gallup poll. The poll asked a cross section of the adult population about the plan advanced by Congressman Goodell. Respondents were asked:

> It has been suggested that 3 percent of the money which Washington collects in Federal income taxes be returned to the States and local governments to be used by these State and local governments as they see fit. Do you favor or oppose this idea?

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[28] *New York Times*, Mar. 24, 1965, p. 18.
[29] *Government for Tomorrow*, Research Paper Sponsored by the Republican Governors' Association and the Ripon Society, July 1965.
[30] *Congressional Record*, Sept. 22, 1965, p. 23853.

The national results showed 70 percent favoring the plan, 18 percent against and 12 percent no opinion. Among independents, 60 percent favor the plan. The same percentage of support prevailed among the Democratic voters polled.

To be sure, the reemergence of the tax-sharing idea in 1966 was not simply a result of Republican efforts. Significant developments took place on Capitol Hill in the closing months of 1966 which gave bipartisan credence to a growing uneasiness about the rise in the number and specificity of Federal grants-in-aid. Senators Muskie and Ribicoff, both Democrats, conducted hearings in the late fall of 1966 which focused in large part on the problems of fragmentation and duplication in the administration of existing Federal aids for States and localities. Senate Majority Leader Mansfield indicated a similar concern about the impact of Federal aid in calling upon the chairmen of the major Senate legislative committees to give priority attention in 1967 to reviews of the organization and administration of existing Federal civilian expenditure programs.

To summarize briefly, the tax-sharing idea came to new prominence in 1964. It was rejected by the President late in 1964 and languished until the end of 1966. At this point, it reemerged as a major domestic policy issue because of (1) Republican interest in new policy initiatives, and (2) widespread concern about administrative rigidities and lack of coordination under the existing "system" of Federal aids.

III. Federal Tax Credit Approach

Tax sharing is not the only way in which emphasis can be shifted away from existing particularistic Federal aids in favor of greater discretion and responsibility at the State level. Another means of providing broad financial support to the States is a Federal tax credit for various States and/or local taxes. As opposed to the Federal tax *deduction* for most State and local taxes as currently allowed, a *credit* would give the taxpayer a full dollar in savings for every dollar credited. This approach has been urged by the U.S. Advisory Commission on Intergovernmental Relations (ACIR), and the Committee for Economic Development (CED). The following numerical examples illustrate the effect of an optional credit for 40 percent of State personal income taxes as suggested on a tentative basis by the U.S. Advisory Commission on Intergovernmental Relations in October of 1965.[31]

NUMERICAL EXAMPLE OF THE EFFECT OF THE ACIR PLAN

If a State without an income tax levied a *new* income tax in response to an ACIR-type tax credit which cost a given individual $100, he would actually pay only an extra $60. Forty dollars (40 percent of his State income tax) would be subtracted from his Federal Individual income tax liability. Assume for the moment that his Federal

[31] The ACIR used a 40-percent optional Federal tax credit for illustrative purposes in its report, *Federal-State Coordination of Personal Income Taxes*, October 1965. By optional, it is meant that the taxpayer has a choice between continuing to deduct his State personal income taxes for Federal tax purposes or taking the new credit for 40 percent of these taxes. Presumably, taxpayers in the plus 40 percent Federal personal income tax brackets would do better continuing to take a deduction. For a full analysis of the tax credit as an instrument for aiding State and local governments, see James A. Maxwell, *Tax Credits and Intergovernmental Fiscal Relations* (Washington: The Brookings Institution, 1962).

income tax would have otherwise been $1,000. It would not be reduced to $960. His total income tax bill after the credit would now be $1,060 ($960 Federal plus $100 State). This is an increase of $60, yet his State would be far better off by $100.

In a State which already has a State income tax, the individual taxpayer would initially receive a net Federal income tax cut. The cut would be equal to the percentage of the Federal credit (40 percent under the ACIR suggested plan) times his State income tax liability. Total State income tax payments in 1965 were $3.6 billion. Until States with income taxes raised their rates, taxpayers in these States would receive the benefit of Federal income tax reductions totaling somewhere between $0.7 billion and $0.9 billion.

However, the tax credit approach in the eyes of many of its proponents assumes that the credit will be "*picked up*" by the States. Using the same dollar amounts as in the previous numerical example, a taxpayer who initially had $1,000 Federal and $100 State income tax liabilities before the credit could pay $66 more in State income taxes and still have the same total tax liability ($934 Federal plus $166 State) after the 40 percent credit had been put into effect and assuming it was "picked up" by his State.

The ACIR estimated that the net cost of this 40 percent optional credit in fiscal year 1967 would be about $730 million.[32] However, with the assumption that States would respond to the credit by relying much more heavily on income taxes, the cost could go considerably higher. For example, should States respond to the 40 percent credit by levying State individual income taxes equivalent to 3.5 percent of Federal taxable income (a very high rate by comparison), the cost of the credit would be an estimated $4.2 billion in fiscal 1968.[33]

PROS AND CONS OF THE TAX CREDIT APPROACH

The main advantage of the ACIR tax credit approach over the general aid approach is that it can be used to stimulate States to rely more heavily on income taxation, which historically has been the least productive of the three broad based State-local tax sources (property, sales, income). Today, one-third of the States do not have any personal income taxes, and another third tax personal income at "relatively low effective rates." [34] State individual income tax revenues of $3.6 billion in 1965 accounted for only 14 percent of total State tax collections, excluding employment taxes.[35]

Another advantage claimed for the tax credit approach over the general aid approach is best expressed in terms of the effect of the credit in clarifying "political accountability." States would have to impose and administer their own income tax to derive any benefit from a credit. Thus, it is argued that there would be a stronger incen-

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[32] U.S. Advisory Commission on Intergovernmental Relations, *Federal-State Coordination of Personal Income Taxes*, p. 117.

[33] *Ibid.* The ACIR calls this 3.5 percent rate assumption "most unlikely." Only a handful of States today have rates approaching this level. See Advisory Commission on Intergovernmental Relations. *Tax Overlapping in the United States 1964*, p. 116, for comparative State data on 1954 and 1964 State individual income tax effective rates.

[34] U.S. Advisory Commission on Intergovernmental Relations, *Federal-State Coordination of Personal Income Taxes*, p. 11.

[35] *Ibid.*, p. 39.

tive to make certain that funds secured as a result of the credit were devoted to priority public expenditure purposes.

A Federal tax credit for a given proportion of State income taxes could also have advantages from the point of view of national tax policy. It would mean that even with a decline in the share of taxes collected at the national level, effective use would continue to be made of income taxation. Proponents of the credit see this as desirable for two reasons: (1) the income tax is more responsive to economic growth than other taxes; and (2) it is an agreed upon and workable means of incorporating a measure of progression into the Nation's global tax system.

Looking at the other side, one of the main general arguments against the credit is that it would not achieve its intended aim of strengthening State-local finances because some States with income taxes invariably would not choose to "pick up" the credit. Instead, they may decide to allow individual taxpayers to take advantage of this new provision, which would mean that in those States the credit would have much the same effect as another across-the-board Federal income tax reduction.

Additional arguments made against the ACIR credit are that it discriminates against taxpayers in nonincome tax States and at the time that it coerces these States into adopting a personal income tax. In income tax States, some taxpayers would receive a net tax cut as a result of the credit, whereas in nonincome tax States many taxpayers would be forced to pay higher taxes in order for their States to take advantage of the credit.

The tax credit approach as a whole also raises difficult problems from the point of view of the lower-income States. A Federal credit for State taxes would tend to give proportionately greater tax relief to taxpayers in the higher income States because they have more taxable income. While it is possible to devise an equalization factor in the credit, this adjustment tends to make the credit so complex as to be almost unworkable on top of our already complex three-layer tax system.

Since its announcement in October of 1965, the ACIR tax credit proposal has not met with what could be considered wide acceptance, partly because of the disadvantages cited here and partly because it came at a time when increased Federal expenditures and inflationary pressures mitigated against any further programs which would add to the Federal deficit. The later point, of course, also applies at present to the various tax-sharing plans. There is always the possibility that when the Federal budgetary situation permits, the tax credit approach will have more political support than the Heller-Pechman or a similar tax sharing plan. [36]

IV. Model Cities Proposal

An obvious alternative to a new generalized aid instrument concentrating on the States, as in the case of tax sharing and tax credits, is more aid for the cities. For this reason, the background, administra-

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[36] The reader may wonder why the pros and cons of the tax credit are included here, but not those of tax sharing approach. The reasons are that this *Compendium* stresses the arguments for and against tax sharing, and furthermore that the author has a contribution in a section which follows stating his reasons for favoring the tax-sharing idea.

tive structure, cost, and rationale of the new model cities program are included in this paper.

On January 26, 1966, President Johnson sent a special message to Congress on "Improving the Nation's Cities." He recommended a $2.3 billion, 6-year "demonstration cities program that will offer qualifying cities of all sizes the promise of a new life for their people." [37] In the designated demonstration areas, the Federal Government would provide financial assistance under existing urban aid programs, *plus:* (1) 90 percent of the costs of planning and development; (2) special supplemental grants of "80 percent of the total non-Federal contributions required to be made to all projects or activities which are a part of the demonstration program and financed under existing grant-in-aid programs;" (3) Federal grants for relocation of families and businesses; and (4) "technical assistance to help carry out these prorams." [38]

As to the administration of the demonstration (or model) cities program, the selection process and the role of the "Federal coordinator" in each demonstration area are of central concern. The President in his message listed 14 guidelines for determining eligibility under the new program. Among the most important are that the demonstration should:

—arrest blight and decay in entire neighborhoods;
—offer maximum occasion for employing residents of the demonstration area;
—provide for relocation of residents and businesses;
—be managed by a single agency with adequate powers;
—maintain or establish a residential character in the area;
—be coordinated with overall metropolitan plans, particularly for transportation; and
—maintain a schedule for the expeditious completion of the project.[39]

In testifying before Congress, Secretary Weaver of the Department of Housing and Urban Development indicated that these guidelines would be strictly interpreted.[40] The Secretary said that about a dozen cities would quickly qualify, and that by the end of 5 years he anticipated that 75 metropolitan areas would be involved covering 60 million people.[41]

Once an application has been approved, the next step would be the appointment of a "Federal coordinator." Referring to the coordinator, the President said in his January 1966 message that he would "assist local officials in bringing together the relevant Federal resources." [42] Secretary Weaver also stressed that the coordinator's role would be to provide "liaison services," and that he would have "no authority over local officials . . . and no power over the programs and activities of that locality." [43] Despite these assurances, many opponents

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[37] U.S. Congress, House, *Message from the President of the United States Transmitting City Demonstration Program*, 89th Cong., second sess., Documental No. 368, p. 4.
[38] Robert C. Weaver, Statement before the Subcommittee on Housing of the House Committee on Banking and Currency, Feb. 28, 1966, p. 1.
[39] *Message from the President*, pp. 4–5.
[40] *Congressional Quarterly*, Mar. 4, 1966, p. 493.
[41] *United States Municipal News*, United States Conference of Mayors, vol. 33, No. 4, Feb. 15, 1966, p. 14.
[42] *Message from the President*, p. 6. Italic added.
[43] Robert C. Weaver, p. S.

of the program in the Congress concentrated on the centrality and power of the coordinator in the affected areas.

FINANCING MODEL CITIES

As enacted in November of this year, the cost of the model cities program (averaging $400 million per year) is well below that of the Heller-Pechman proposal ($2.5 billion estimated for 1964), and is roughly half of the low estimate of the ACIR tax credit ($730 million). Appropriations support has been at even lower levels. Nevertheless, it is quite clear that for the model cities program to achieve its intended long-range objectives will require major infusions of new funds in future years. Various organizations of municipal officials have already gone on record that the originally proposed $2.3 billion, 6-year program is not anywhere near large enough to meet current needs. Mayor Jerome P. Cavanagh of Detroit, in testifying before the Housing Subcommittee of the House on behalf of the National League of Cities and the U.S. Conference of Mayors said, "we should recognize that $2.3 billion is a start—*and nothing more.*"[44] The National Housing Conference and National Association of Housing and Redevelopment Officials have also questioned the adequacy of the original $400 million per year figure.[45]

The model cities program is certainly not the same as a general aid plan for cities. Aid is limited to approved urban development projects, and then only in selected cities. However, because this program obviously can be very expensive in the long run (thus detracting from the ability of the Federal Government to finance alternative major new domestic expenditure programs) and because it is intended to allow considerable discretion to local officials, it can be viewed as a new Federal-aid policy alternative on much the same footing as the Heller-Pechman plan. This, of course, does not rule out a *compromise.* Federal funds in the future could be provided for the two programs, thus satisfying both the central city and State factions. The types of considerations which must be taken into account in developing such a comprise are discussed briefly in the conclusions of this paper.

V. Regional Aid Approach

The fifth major Federal-aid policy alternative envisions that neither States nor localities, as such, would receive the lion's share of new Federal-aid funds. The funds would go instead to regional groupings of states and/or counties on a basis patterned after the Appalachia regional economic development program enacted in 1965. Other regions are already moving forward on plans for broad regional development programs. Moreover, should the Appalachia program succeed in its initial phase, there is every reason to anticipate that additional Federal funds would be sought for this region as well.

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[44] Jerome P. Cavanagh, statement before the Housing Subcommittee of the House Banking and Currency Committee, Mar. 2, 1966, p. 5 Italic added.

[45] *Nation's Cities,* Magazine of the National League of Cities, vol. 4, No. 4, April 1966 p. 28.

THE APPALACHIA PLAN

As enacted, the Appalachian Regional Development Act of 1965 provides $1.1 billion in new aid for depressed counties in 12 States.[46] Federal aid is designated for several major types of programs, by far the largest amount ($840 million over 5 years) being for highways. Aid is also provided for demonstration health facilities, land improvement and erosion control, timber development, mining area restoration, water resources, vocational education, sewage treatment, and for matching funds under existing Federal grant-in-aid programs.[47]

The supervision and coordination of the Appalachia program is vested in the Appalachian Regional Commission consisting of the Governor of each participating State, or his representative, and a Federal representative named by the President. Decisions in the Commission are made by majority vote of the States with the Federal representative concurring. This, in effect, gives the Federal representative a veto power.

THE 1965 EDA ACT

In addition to the Appalachia program, the Federal Government has taken steps to encourage the development of the regional approach to economic development in the Public Works and Economic Development Act of 1965. This act extends and replaces the former Area Redevelopment Act. The new act emphasizes regional planning as opposed to the previous approach of relying entirely on individual communities or counties.[48]

Even though the regional approach is regarded as an important part of the 1965 EDA act, the funds involved for regional economic development purposes are small by comparison to the total. Title VI of the act of 1965, which directs the Secretary of Commerce to encourage the development of multistate regional planning commissions, makes an initial authorization for this purpose of $15 million.[49] This is less than 5 percent of the total $3.25 billion 5-year authorization under the Public Works and Economic Development Act of 1965.

It is probably safe to assume that until further experience is gained with these various multistate commissions the Federal Government will be reluctant to make large increases in appropriations for regional economic development purposes. Thus, it may be awhile before this approach actually emerges as a major new Federal-aid alternative on a scale commensurate with the Heller-Pechman plan, the ACIR tax credit, and the model cities program.

VI. CONCLUSION

Taking all five of these Federal aid alternatives together, they point up the importance for the future of comprehensive and clearly thought

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[46] See Jerald Ter Horst, "No More Pork Barrel: The Appalachia Approach," *Reporter*, Mar. 11, 1965, p. 27.

[47] Funds for these programs are authorized for 2 years, whereas the highway funds are authorized for five. Taken together, the planned annual expenditure rate is approximately $200 million per year.

[48] According to the *Washington Post* (May 14, 1967), the regions moving ahead the fastest on the development of regional economic plans are: New England, the Coastal Plains (North and South Carolina and Georgia), the Ozarks, the Upper Great Lakes, and the "Four Corners" (parts of Utah, Arizona, Colorado, and New Mexico).

[49] *Congressional Quarterly*, Aug. 20, 1965, p. 1635.

out post-Vietnam fiscal policy planning.[50] Should "fiscal drag" recur, and should support buildup for devoting additional Federal resources to domestic public expenditures at the State-local level, the need will be to strike some kind of a compromise which is regarded as fair from the viewpoint of the lower income States, the poverty areas of deteriorated central cities, developing economic regions, and the wealthier States as a whole. Tax sharing, model cities, tax credits, regional economic development aid, and expanded reliance on narrowly defined and more traditional types of Federal aids can be combined in any number of ways. It is therefore essential that attention be given on a comprehensive basis to the economic and equity aspects of policy decisions in this area, as well as to the fundamental political questions raised about the future of American federalism. The amount of Federal aid now being provided to States and localities and the potential for the years ahead (if recent growth trends are any indication) are so large that the failure to plan ahead on a rational basis could result in serious discrimination against certain types of areas, whether it be the lower income States, the core areas of the large metropolitan areas, or some other grouping of States and/or localities.

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[50] It should be noted that the President in his 1967 Economic Report called for the establishment of an interdepartmental committee for precisely this purpose, what might be called peace contingency planning.

THE FEDERAL GOVERNMENT AND THE STATES*

BY THE SUBCOMMITTEE ON ECONOMIC PROGRESS, JOINT ECONOMIC COMMITTEE

A related question is the appropriate level of government at which a given program should be conducted. A number of recent studies have pointed out a possible "fiscal mismatch" between needs and resources. Under nonwar conditions, the supply of readily available Federal revenues appears to rise faster than current demands on the Federal purse, but the State-local situation is the reverse; expenditure demands on State and local governments rise faster than readily available revenue supply.

The so-called Heller proposal for block grants to the States is one of a family of possible ways in which the financial resources of the Federal Government can be utilized to assist State, county, and city governments. As shown in table 17, other methods of utilizing the potential increase in Federal revenues include expanded program or tied grants, tax sharing, individual Federal tax credits for State and local taxes paid, and new direct Federal activities in the various localities.

TABLE 17.—*Alternate methods of utilizing potential increases in Federal revenue to aid State and local governments*

Method	Analysis of effects					
	Federal role in economy	Federal influence on States	Income equalization	Tax progressivity	Built-in stabilizers	Role of cities
Direct Federal programs	+	0	+	0	0	0
Tied grants	0	+	+	0	0	0
Block grants	−	0	+	0	0	−
Tax credits	−	0	−	0	0	−
Tax sharing	−	0	0 or +	−	−	+
Federal tax reduction	−	0	0	−	−	0

NOTE.—Legend: Increase is +; no change is 0; decrease is −.

It may be helpful to examine these alternative ways to deal with the fiscal situation that may become prevalent in the 1970–75 time period.[1]

Some of the potential increases in Federal revenue could be devoted to new activities to be conducted by the Federal Government itself in all 50 States. This approach would call for the largest amount of Federal intervention, since no provision would be made for State or

*Reprinted from *U.S. Economic Growth to 1975: Potentials and Problems*, Joint Committee print, Subcommittee on Economic Progress, Joint Economic Committee, 1966, pp. 42–44.

[1] Cf., M. L. Weidenbaum, "State Needs and Federal Funds," Business Topics, Winter 1966.

local government participation. There would be State and local benefits to the extent that facilities would be provided which otherwise would have to be financed locally.

This approach, which would require abstaining from reductions in Federal income taxation, would maintain the progressivity of the overall tax structure and the role of the built-in or automatic stabilizers. Depending on the type of expenditure programs selected, the impact on income distribution could be more or less equalizing.

An alternative would be to expand the use of "tied" or conditional grants to State and local governments for specific functions. This approach would make the Federal Government an even more important influence in State and local fiscal operations. Use of conditional grants would not affect the progressivity or stabilizing effects of the tax structure. Most Federal grant programs have an income equalization effect because Congress often uses allocation formulas based on population or income.

One proposal for block or unconditional grants would set up a permanent trust fund to distribute an amount equal to 2 percent of the Federal income tax base among the States on a per capita basis. This approach would reduce the role of the Federal Government both in the national economy and in relation to State and local government action. It would also exercise a moderately equalizing effect between high-income and low-income States, but would not affect the overall progressivity of the tax structure or the importance of the automatic stabilizer. This method might be far from an unmixed blessing for urban areas because Federal funds would be funneled entirely through the State governments. Some methods could be developed to include local as well as State governments as recipients of the Federal funds, thus changing the effect shown in table 17.

Alternatively, a portion of Federal revenues could be distributed to the States on the basis of source of collection. This would result in high-income States, with high tax payments, receiving the larger shares. The State governments would be left free to determine the allocation of their funds. The effects on overall tax progressivity and stability would be the same as block grants.

Tax credits would provide Federal income taxpayers a more liberal writeoff of State and local taxes by giving them an option either to deduct their State and local taxpayments from taxable income, as they can do now, or to deduct some portion of State and local taxpayments from their Federal tax bills. The major benefits would accrue to persons in the low and middle tax brackets who carry above-average State tax loads. This method could help local, as well as State, governments by softening resistance to increases in State and local taxes.

Outright reductions in Federal taxes would be an indirect way of aiding State and local governments. This would permit them to increase their tax rates without increasing the total tax bill of the average citizen, but introduces questions of interstate rivalry. The overall national tax structure would become less progressive (as well as less anticyclical), because the Nation would be placing greater reliance on frequently proportional and regressive State and local taxes. The role of the Federal Government, both in relation to State

and local governments and to overall economic activity would be diminished with a reduction in its fiscal resources.

In a society with plural objectives, no single fiscal approach would satisfactorily meet more than a few of them—and might adversely affect other goals. Direct Federal expenditures might optimize income stabilization and income redistribution objectives, but bypass both State and local governments. Tax reduction decreases the size of the Federal sector, but meets State and local public needs only indirectly, if at all. Tax sharing and block grants provide for the allocation of public funds among programs to be made individually by the States, who presumably are more familiar with the needs and desires of their residents than the National Government; but questions have been raised about the adequacy of provisions for the burgeoning financial requirements of counties, school districts, cities, and towns.

FEDERAL, STATE, AND LOCAL FISCAL RELATIONS*

BY THE COUNCIL OF ECONOMIC ADVISERS

Since World War II, State and local expenditures have been growing far more rapidly than Federal outlays. To finance their budgets, these governments have increased tax rates and assessments frequently; yet State and local debt has increased sevenfold. Over the same period, Federal receipts have generally kept pace with expenditures in peacetime, despite reductions in tax rates; and the net Federal debt has risen only one-fifth, falling sharply in relation to GNP.

The problem of matching revenues with expenditure responsibilities is a never-ending one in our Federal system. Partly by historical accident Federal Government has developed the best source of revenue; namely, the income tax. But increasing urbanization and other factors have swelled the demand for public services which are regarded as primarily the responsibility of State and local governments—both by tradition and by the preference of the American people for keeping government as close to home as possible.

TAXATION

The Federal Government obtains two-thirds of its revenues from taxes on personal and business incomes. Despite its imperfections, the Federal individual income tax is one of the best taxes ever devised. By taxing larger incomes at higher rates, it squares with the American notion of equity. Its revenue yield rises strongly as the economy grows. It serves as a built-in stabilizer by varying with economic fluctuations. By comparison with other taxes, it interferes least with job choices and expenditure decisions.

The States rely principally on sales and excise taxes, and local governments on property taxes. Broad-based personal income taxes, now levied by 33 States, were enacted in most cases before the Federal Government began to draw heavily on this source in World War II. A small number of cities use "income" taxes—usually in the form of payroll levies. Tables 26 and 27 show the relative importance of different sources of revenue and of expenditure requirements in 1965.

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*Reprinted from *The Annual Report of the Council of Economic Advisers*, January 1967; Chapter 4 "Selected Uses of Economic Growth," pp. 161–169.

TABLE 26.—*Federal and State and local government receipts, by source, national income and product accounts, 1965*

Source	Amount (billions of dollars)		Percentage distribution [1]	
	Federal Government	State and local governments	Federal Government	State and local governments
Total receipts	124.9	75.3	100.0	100.0
Individual income taxes [2]	51.3	4.4	41.1	5.9
Licenses, fees, and other taxes and charges on persons	2.9	7.4	2.3	9.8
Corporate profits tax accruals	29.1	2.0	23.3	2.7
Sales and excise taxes and customs [2]	15.8	15.9	12.6	21.1
Real estate and business property taxes		23.1		30.7
Other business taxes, fees, and charges	1.1	6.9	.9	9.1
Contributions for social insurance	24.8	4.5	19.8	5.9
Federal grants-in-aid		11.2		14.9

[1] Based on receipts in millions of dollars.
[2] Less tax refunds.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

TABLE 27.—*Federal and State and local government expenditures, by major function, national income and product accounts, 1965*

Function	Amount (billions of dollars)			Percentage distribution [1]		
	Federal Government		State and local governments	Federal Government		State and local governments
	Total excluding grants-in-aid	Grants-in-aid to State and local governments		Total excluding grants-in-aid	Grants-in-aid to State and local governments	
Total expenditures	112.2	11.2	73.7	100.0	100.0	100.0
Defense, space, veterans, and international	66.0	.4	.4	58.9	4.0	.6
Education	.5	.7	28.9	.5	6.6	39.2
Health, hospitals, and sanitation	1.2	.7	7.6	1.1	6.3	10.3
Social security, welfare, and labor	23.1	4.5	7.1	20.6	40.3	9.6
Police, fire, and correction	.1		5.1	.1		6.9
Highways	.1	3.8	11.3	.1	34.2	15.3
Postal services, public utilities, commerce, and nonhighway transportation	2.6	.1	1.6	2.3	.5	2.1
Housing, community development, and recreation	.3	.5	1.6	.2	4.6	2.1
Agriculture and natural resources	5.9	.3	1.5	5.3	3.1	2.0
Interest and general government	12.3	(2)	8.8	11.0	.4	11.9

[1] Based on expenditures in millions of dollars.
[2] Less than $50,000,000.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Department of Commerce.

Sales and property taxes are regressive. A poor family pays a substantial sales tax in most States even if it owes nothing under the Federal income tax. Sales taxes also discriminate among taxpayers in similar economic circumstances. Families with the same incomes but different patterns of consumption may pay different amounts; and large families may bear a relatively heavier burden than small families. Moreover, the yield of sales taxes is less responsive than that of income taxes to economic growth. Property taxes, which are the major

source of financing for education, are especially objectionable to homeowners who have no children and cause hardships for those who own their own homes but have relatively low current incomes. They can also discourage private efforts to rehabilitate and upgrade declining neighborhoods. Because so much trade and commerce is interstate, attempts by States to tax sales and income often make administration complex and costly and create problems in taxpayer compliance and frictions among States in apportioning revenue sources.

State and Local Fiscal Problem

The States and localities have not been idle in the face of mounting demands for public services. Since 1959, for example, the 50 States have enacted about 200 increases in the rates of their major taxes, and imposed 15 new taxes, including eight new retail sales taxes.

In the years ahead, the financial pressures on States and localities in the aggregate may moderate somewhat. The age category that produces the largest per capita need for public services—school-age children—will grow less rapidly than the working age population. Nevertheless, pressures will still be strong, especially to meet the massive problems of cities imposed by decades of neglect. According to detailed estimates recently made for the Joint Economic Committee, construction needs of State and local governments in the next decade will equal those of the last decade.

Thus the financial problems of State and local governments will persist. Currently, increased defense expenditures dominate the Federal budget picture. But over the long run, there is every prospect of a return to the fiscal paradox of recent years—booming income tax revenues for the Federal Government while States and localities struggle to finance their massive program requirements.

Categorical Federal Aid

The Federal Government now provides many grants-in-aid in support of specific categories of State and local expenditure. Federal grants now constitute about one-sixth of total revenues of State and local governments. The first large Federal grant programs were for emergency relief and public assistance during the 1930's. Federal grants declined during World War II, but then grew rapidly in the 1950's, with highway construction grants producing an acceleration in the second half of the decade (table 28).

The last few years have seen a rapid acceleration of Federal aid through a variety of new or expanded programs—most notably for elementary and secondary education and to combat poverty. In fact, most new legislation in areas discussed in this chapter operates through grants or loans to State and local governments.

The grant-in-aid approach is flexible. It enables the Federal Government to single out the most urgent needs and to apply suitable remedies directly. Furthermore, by imposing matching formulas where appropriate, the Federal Government often can enlist additional State effort in neglected areas. Variable matching requirements are used by the Federal Government to pay for a greater share of costs

TABLE 28.—*Growth of Federal aid to State and local governments, fiscal years 1930–68* [1]

Function	1930	1940	1950	1955	1960	1965	1968 [2]
	Billions of dollars						
Total Federal aid	0.1	2.4	2.3	3.3	7.0	10.9	17.4
Health, labor, and welfare	(3)	2.2	1.6	1.9	2.9	4.4	8.0
Commerce and transportation	.1	.2	.5	.6	3.0	4.4	4.3
Education	(3)	(3)	(3)	.2	.4	.6	2.5
Housing and community development	(3)	(3)	(3)	.1	.3	.6	1.3
Agriculture and agricultural resources	(3)	(3)	.1	.2	.2	.5	.6
Natural resources	(3)	(3)	(3)	.1	.2	.3	.5
Other	(3)	(3)	(3)	.1	.1	.1	.2
	Percent						
Federal aid as percent of—							
Federal expenditures [4]	4.3	25.6	5.3	4.8	7.7	9.2	10.3
State and local expenditures [4]	1.4	25.3	10.5	10.4	14.7	15.4	18.7

[1] Grants-in-aid and shared revenues from both administrative budget and trust funds.
[2] Data for 1968 are estimates.
[3] Less than $50,000,000.
[4] National income and product accounts basis.

NOTE.—Detail will not necessarily add to totals because of rounding.

Source: Bureau of the Budget.

in States and areas where needs are greatest relative to available resources. Federal grants can encourage innovation at the local level, and provide for experimentation and demonstration where the problems are more obvious than the remedies. They can be launched modestly and expanded upon demonstration of effectiveness. The grant approach can spur better planning and coordination among overlapping or adjacent—and sometimes conflicting—local jurisdictions where a regional or areawide problem requires a cooperative and coordinated attack.

At the same time, the categorical grant mechanism is open to some criticisms. State and local officials are sometimes bewildered by the number, variety, and complexity of eligibility and matching provisions of different Federal aid programs. A special effort is necessary to keep them informed of latest developments, so that all eligible units of government may share equitably. And some localities resent Federal standards and "supervision" in grant programs.

BROADENING THE SCOPE OF FEDERAL GRANTS

Supporters of categorical aid argue that, while there may be faults in the present system, they are not intrinsic. Many steps have already been taken to improve grant programs. The Bureau of the Budget has undertaken recently to improve the coordination of Federal programs at the State and local level. The Partnership in Health Act of last year combined several small, categorical grant authorizations into one and provided assistance for planning comprehensive health services. Similarly, the Model Cities program provides for the coordinated use of funds from a number of separate categorical programs as well as from private and local government sources; it also authorizes Federal assistance for local government programs in the demonstration

area of the city even if these would not qualify for any categorical aid. The Community Action Program offers cities support for a broad range of activities that fit into a coordinated attack on poverty.

These new programs of broad support represent a major evolution from many traditional types of categorical grants in which the Federal Government pinpoints the State and local expenditures it will support.

These developments are viewed by some observers as a decisive argument for an evolutionary approach that continues to rely on categorical aid as the principal vehicle by which Federal assistance should be given to State and local governments. These observers would argue that effectiveness is limited only by the amounts that the Federal Government can afford to channel to States and localities, rather than by any inherent defects in the mechanism of categorical aid.

General Support Grants

Others contend, however, that broader "general support" grants are needed as part of Federal support to States and localities. In principle, these grants would have no strings attached, and would be available for general budget support rather than tied to specific activities or programs. Direct transfers without supervision would leave the States and cities free to set priorities and to design remedies for local problems. The unconditional grant approach lends itself readily to "equalization," to take account of differences in income levels and fiscal capacity among the States. Many proposals recommended setting the size of such grants as a percentage of collections under the Federal individual income tax. One would earmark 5 percent of collections from the Federal individual income tax for general support grants to the States.

Critics of general support grants have questioned whether State governments would spend the added revenues wisely, whether they would maintain their own revenue efforts, and whether they would provide adequately for their own cities. Unconditional grants to the States are viewed by some as a threat to additional congressional appropriations for categorical grant programs which provide direct assistance to cities and their pressing problems. Also, if States had a claim on a share of Federal revenues, they might oppose Federal tax reduction even when needed to combat recession. And if the cut were nevertheless approved, its effectiveness could be weakened by a resulting cutback in State outlays.

Supporters of revenue-sharing point out that formulas can be devised to cope with cyclical swings in general support grants and to channel funds to localities as well as States. However, there are obvious difficulties.

Under some proposed compromise arrangements, a fixed level would be established for total Federal financial aid to State and local government, designed to cover both categorical grants and general support. Categorical grants would continue to be appropriated as at present; and the balance of the support would take the form of untied grants going to cities as well as States. The untied portion would serve as an "overhead" payment to be used by States and cities to strengthen their own programs and their planning. Such a compromise is intended

to provide some assurance of continued Federal support for categorical grant programs which have established their merit, while enlarging opportunities for State and local initiative and responsibility.

Credit for State Income Taxes

An additional method of enlarging State revenues in the context of an improved overall national tax structure has been proposed by the Advisory Commission on Intergovernmental Relations. The suggestion is that a credit against Federal personal income tax liability be given for up to 40 percent of State income taxes paid. This credit would provide powerful incentives: the 17 States which do not now have broad-based individual income taxes would be strongly induced to enact them; States which already have income taxes would be encouraged to rely on them more heavily. A State could then augment its revenues through income taxation with a net increase in the burden on State taxpayers equal to only 60 percent of added revenue. Through the credit device, the States would, in effect, be collecting part of their income taxes from the Federal Government.

Federal tax credits to influence local tax policy are not new. They are applied to estate or inheritance taxes paid to States, and they are used under the Federal-State unemployment insurance system.

The tax credit device has been subjected to certain criticisms. First, by their very nature, tax credits provide more help to rich States than to poor States, because the amount of assistance depends on the tax base of each State. Second, the proposal does not in itself provide direct aid to the cities. Third, the Federal tax credit adds to State revenues only when and if the States act to initiate or raise rates on income taxes; the initial impact merely lowers Federal taxes for people who now pay State income taxes.

Joint Revenue Collection

It has also been proposed that the Internal Revenue Service (IRS) expand its current assistance to the States in their income tax collection efforts. At present, there is cooperative exchange of information between Federal and State revenue officials. But the IRS could act as collecting agent for State income taxes. The State rate structure would be applied against the Federal definition of taxable or adjusted gross income or Federal tax liability itself. Joint revenue collection is a modest proposal which could be enacted on its own merits or as a supplement to the larger plans. It might encourage additional States to enact income taxes, and should certainly simplify life for both taxpayers and revenue officials in States which already use income taxes. It would, of course, be necessary for the States to follow Federal concepts of taxable income, which may not always accord with their own.

Other Issues of Coordination

Among other problems requiring better coordination of Federal-State-local taxation is one dealing with the exemption from taxation, under the Federal individual income tax, of interest paid on State and local government securities. Because of the exemption, these governments can borrow more cheaply—paying lower rates of interest

and competing more effectively for funds against other borrowers in capital markets. However, the exemption also reduces the progressivity of the Federal individual income tax, since it produces much bigger tax savings to those in high income tax brackets than to those taxable at lower rates. This is a relatively inefficient means of channeling aid: the Federal Government loses far more revenue than the States and cities gain in reduced interest costs.

Apart from the general question of interest exemption, and of immediate concern, is the use of so-called industrial development bonds. Through the use of these bonds, localities have passed to private industries the benefit of the exemption of their interest from Federal tax, in many cases without assuming any real obligation for repayment of the bonds. This questionable practice is becoming increasingly widespread, and the lack of any obligation by the locality authorizing the bonds permits proliferation without limit. The use of the Federal tax code in this fashion is inefficient and inappropriate.

Another fiscal problem concerns State taxation of corporate income. Since most corporate income is generated by interstate corporations, States must establish formulas to apportion the income assumed to be earned from business done in other areas. The formulas give various weights to such factors as location of plant, percent of payroll, sales destination, location of sales offices, and "origin" of sales. In 1966, after several years of study, the House Judiciary Committee recommended legislation that would require a uniform State formula based solely on two factors, property and payroll. The States have responded unfavorably to this proposal. As an alternative, additional Federal grants to the States might be used to persuade them to relinquish a tax which is more efficiently collected at the national level.

CONCLUSION

Expenditures for income maintenance, health, and education, and revenues of States and cities, have grown faster than GNP since the mid-1950's. Expenditures for educational services and health care combined have risen from about 8½ to 12½ percent of GNP, and expenditures of States and localities have expanded from 8½ to 11 percent of national output in the past decade. Federal transfer payments to persons have risen from 3 to 4½ percent of GNP. Through their dollar votes on the market and their votes at the polls, Americans have reaffirmed their strong desires for greater expenditures in these areas.

In response to the wishes of the public, these areas will continue to absorb a significant fraction of the gains from economic growth. But it is impossible reliably to forecast how rapidly these outlays will grow, or to set in advance meaningful targets for how fast they should increase. Opportunities for progress in these areas will be influenced by the urgency of competing claims on output, ranging from national defense to the unlimited aspirations of private consumers, and from conservation of natural resources and improvements in the quality of our environment to industrial research, development, and investment. In peacetime the Nation will face repeated and difficult—though welcome—choices about how to distribute fiscal dividends between public programs and tax reductions. These decisions should be responsive to changing circumstances.

Moreover, it is not possible to stipulate "needs" in the areas discussed in this chapter. If needs are merely what survival requires, most of what is needed is now available. And if needs are everything that could be reasonably desired, then they will not fully be met for generations.

A rational balancing of opportunities and alternatives, will undoubtedly call for some progress in all of these—and other—priority areas. Most of the choices, both public and private, will be incremental in character. The individual chooses whether or not to visit his dentist, weighing the need against other uses of funds; he does not decide on health in the abstract or in the large. Similarly, the Federal budgetary process is full of efforts to cut low-priority expenditures marginally in order to expedite a promising new program like model cities. Even major program decisions which will be faced in the years ahead—such as whether or not to set a minimum income floor to combat poverty, or whether or not to select any of the proposed innovations in the area of Federal-State-local fiscal relations—could also be approached on an incremental basis. In making these budgetary decisions, it is vitally important that goals and objectives be defined precisely, that all alternative methods of reaching them be considered, that costs and benefits be quantified as far as possible; only then can the most efficient means of achieving the objectives be chosen. The planning-programing-budgeting system recently initiated by the Bureau of the Budget and the executive agencies of the Federal Government is designed to advance this systematic approach.

This chapter has attempted to raise some issues which will require difficult choices. Collectively such decisions will determine the directions of social progress in the years ahead.

It is clear that social progress will make important claims on the Federal budget. There is no easy way to define the Government's appropriate role. But the pursuit of public interest and the exercise of public responsibility need not add dollar for dollar to the bills of taxpayers or to the size of Government. Much of our advance in health, education, and cities will be financed through the budgets of consumers and businesses. The energies and outlays of private enterprise can be stimulated by wise and imaginative public policies relying on enlightened regulation, carefully designed fees and subsidies, appropriate tax provisions, Government loans and insurance programs, and improved functioning of the market economy so that actual prices become better signals for estimating social costs and benefits.

Within the public sector, another set of issues arises: whether particular programs can be administered and financed most effectively by Federal, State, or local governments, and how the overall division of responsibilities can assure adequate financing for priority social needs through an equitable tax system.

The aspirations for material and social progress are boundless; the limits of our potential progress are set by the resource costs and the level of productivity in our society. It can be confidently forecast that the problem will be to find the means to fulfill our public and private aspirations rather than to deal with any redundancy of resources. A decade from now, major gains will have been made, but there will still be a large inventory of unmet desires and unsolved social problems, requiring public and private efforts to channel a substantial additional portion of our growing output toward priority uses.

TECHNIQUES FOR SOLVING INTERGOVERNMENTAL FISCAL PROBLEMS, AND TECHNIQUES OF FISCAL POLICY*

BY BERNARD P. HERBER

SEPARATION OF REVENUE SOURCES

Several alternate approaches may be directed toward the solution of vertical and horizontal intergovernmental budgetary problems. The most comprehensive of these alternatives involves the separation of revenue sources between the various levels of government. To an extent, the Constitution provides a basis for separation of revenues. Customs duties (tariffs), for example, may be collected *only* by the Federal Government. Furthermore, the Constitution in effect prohibts the imposition of a Federal property tax since it would have to be apportioned in accordance with the population of each State.

In practice, the revenue structure of the U.S. public sector bears considerable resemblance to a separated revenue system. The vast majority of revenues which are collected from individual and corporation income taxes, from selective sales taxes, and from inheritance, estate, and gift taxes are collected by the Federal Government. The vast majority of general sales tax receipts and motor vehicle and operator license revenues are collected by State governments. Meanwhile, local government absorbs an extremely high proportion of property tax receipts.

Complete separation of revenue sources between the Federal, State, and local components of the public sector may appear on the surface to be a utopian arrangement. Closer analysis, however, demonstrates that such is not the case. Admittedly, the complete separation technique would eliminate multiple taxation on an interlevel basis with its attendant problems. In addition, it would preserve State-local autonomy as compared to the conditional tax-sharing, tax supplement, tax credit, and tax deduction techniques (to be discussed later in this chapter). Nevertheless, several important qualifications offer opposition to the technique of completely separating tax revenues.

First, there are not enough potentially good tax sources to adequately serve the three levels and some 90,000 government units which comprise the American public sector. An overriding constraint of revenue scarcity is thus imposed. This constraint cannot be alleviated merely by separating tax revenue sources between the three levels of government. In addition, considerable economic differentiation exists within

*Reprinted from Herber, Bernard P., *Modern Public Finance*. Richard D. Irwin, Inc., Homewood, Ill., 1967; ch. 9 "The Aggregate Public Sector Budget—Intergovernmental Fiscal Relations."

the State and local levels of government. Consequently, a rational tax structure for one State or local governmental unit will probably be significantly different from that of another. For example, the resource base of one State or locality, which largely generates its income base (from which ultimately all taxpaying ability derives), may differ greatly from the resource combinations of another State or locality. Fiscal irrationality surely would result if two highly differentiated States or communities had identical tax structures.

Another defect in the separations approach concerns its lack of symmetry in considering only the tax side of the aggregate public sector budget. The spending side of the budget, which can influence allocation, distribution, stabilization, and growth with force equal to that of the revenue side, is ignored by the separations approach. In addition, the separations technique does not provide the complete intergovernmental uniformity in tax rates, exemptions, and so forth which would be necessary to eliminate intergovernmental competition for industrial location—a practice with significant connotation regarding efficient resource usage. A related consideration involving the asymmetry of the separations approach concerns the fact that it may frustrate the collective value judgments of the society regarding minimal living standards of the population. Such value judgments ordinarily suggest that a minimum (ex post) real income distribution be attainable for the residents of all States and communities. Federal grants-in-aid to States and their subdivisions for such things as highways, public assistance, and unemployment compensation programs exemplify this attitude. Yet, the asymmetrical nature of the separations approach prevents it from working toward the equalization of minimal consumption of certain basic economic goods between States and localities.

Furthermore, the separations technique would likely distort any distribution objective based upon the desirability of a progressive tax rate system for the public sector as a whole. For example, "complete tax separation" in the United States would undoubtedly consist of the exclusive use of income taxes by the Federal Government, the general sales tax by State governments, and the property tax by local governments. Complete revenue separation along these lines would thus result in a public sector revenue structure containing significant "regressive" elements in the form of general sales and property taxes.[1] Under such conditions, the distribution goal in question would not be attained.

A final qualification regarding use of the tax separation device concerns the stabilization and growth branches of public finance. Considerable budgetary rigidity would necessarily accompany complete tax separation. Yet, changing conditions of the business cycle and changing growth rates will affect the revenue yields of the "separated taxes" as well as the functional spending needs of the various levels and units of government. The inflexibility of a revenue separation system, however, would restrict the appropriate budgetary adjustments required for anticyclical and growth policies as well as for the maintenance of allocation and distribution goals.

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[1] This result would assume the exclusion of grants-in-aid.

TAX SHARING

This solution to intergovernmental fiscal problems has received much discussion in the United States and is in moderate use at the present time. Certain phases of this approach, moreover, are now being considered for significant future expansion.[2] *Tax sharing*, broadly defined, involves a government unit at a higher level collecting tax revenues prior to the disbursement of some part of these revenues to government units at a lower level or levels, the disbursements falling into conditional (strings attached) and unconditional (bloc) categories.[3] There is strong evidence that the most efficient governmental scale for revenue collection tends to be at a higher level of government than is the most efficient scale for expenditure decisions.[4] Thus, comparative efficiency advantages are followed for both the revenue and expenditure sides of the budget when the tax-sharing technique is employed. However, the lack of a symmetrical *quid pro quo* correlation at each level of government between the two flow sides of the budget remains a problem.

In the United States, conditional tax-sharing plans are used more extensively than are unconditional plans.[5] The Federal Government is involved in many conditional grant-in-aid programs to State and local governments. State governments, in addition, conduct certain conditional grant-in-aid programs for which local units of government are the recipients. Regarding unconditional grants-in-aid, virtually no use is made of this bloc-grant, no-strings attached, device between the Federal Government and lower levels of government in the United States. Moderate usage of unconditional bloc grants is undertaken by State governments, however, in their fiscal relationships with local governments.

Table 9-1 displays the functional programs through which the Federal Government provided aid to State and local governments in fiscal years 1965, 1966, and 1967. Two types of grants-in-aid appear; namely, grants-in-aid paid from General Treasury funds and those used for programs which operate under separate trust funds. In each type of program, however, the grants-in-aid are conditional in nature. The Federal Government during fiscal 1967 distributed more than $10 billion in grants-in-aid through the General Treasury budget and over $4.5 billion through the trust fund accounts.

More than one-half ($6.1 billion) of the general Treasury grants went for the health, labor, and welfare expenditure category. By far the largest proportion of this amount was used for public assistance grants, including aid for dependent children, the needy aged, and the blind. The remainder of health, labor, and welfare expenditures were for such functional activities as health services and research, labor, manpower, and vocational rehabilitation. Other sizable expenditure areas within the general Treasury category—aside from those for health, labor, and welfare—include the education, the housing, and

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[2] See the discussion of the Heller plan later in this chapter.

[3] The author uses a "comprehensive" definition of tax sharing due to the fact that even such intergovernmental assistance as conditional grants-in-aid still must derive utlimately from the revenue collections of the higher level of government. Thus, why should they not be considered as tax sharing?

[4] See the relevant discussion in ch. 8 and, to a lesser extent, the discussion earlier in this chapter.

[5] "Trust fund" grants-in-aid such as the Federal interstate highway program will be discussed in detail in ch. 16. Hence, the total discussion of grants-in-aid in this chapter will be reduced accordingly.

TABLE 9-1.—*Federal aid to State and local governments by form of aid and function, 1965 fiscal year, and 1966-67 estimates*

[In millions of dollars]

	1965	1966 estimate	1967 estimate
Total aid to State and local governments	11,127.4	13,299.8	14,646.7
Grants-in-aid, budget accounts	6,346.4	8,520.3	10,020.1
Veterans services and benefits	8.1	9.4	8.7
Health, labor, and welfare	4,084.2	5,729.6	6,114.3
Public assistance	2,787.2	3,240.8	3,306.2
Health services and research	448.1	544.1	733.1
Labor, manpower, and vocational rehabilitation	124.0	253.4	318.3
Other welfare activities	272.2	364.1	288.8
Education and general research	610.3	1,024.2	2,031.0
Agriculture and agricultural resources	517.6	541.3	428.1
Natural resources	107.1	163.5	193.1
Commerce and transportation (except highways)	406.5	289.4	280.2
Housing and community development	559.2	688.4	877.6
General government	15.8	36.6	43.0
National defense	33.3	33.2	38.8
International affairs and finance	4.4	4.8	5.2
Grants-in-aid, trust funds	4,372.8	4,374.6	4,530.4
Highway trust fund	3,979.5	3,923.2	4,027.8
Unemployment trust fund	393.3	450.4	500.6
Other revenues	408.1	404.8	96.3

Source: "Special Analyses, Budget of the United States, Fiscal Year 1967" (Washington, D.C.: U.S. Government Printing Office), pp. 138-143.

community development, and the agricultural categories. Meanwhile, the grants-in-aid channeled through trust fund financing primarily consisted of the highway and unemployment insurance trust funds.

The grant-in-aid approach for Federal Government revenue support of State and local government activities dates back many years. Most of the growth in this approach, however, has occurred during the last 30 years. Some significant early examples of Federal aid to lower levels of government include: (1) the disposal of the Federal Treasury surplus by President Andrew Jackson in 1836-37 and (2) the Morrill Act of 1862 which led to the establishment of State land-grant universities.

Projections for the future suggest that significant absolute and relative growth in the use of Federal grants-in-aid will occur in such functional areas as health, labor, and welfare, education, and in-housing and community development. This is predicted to be part of a continuing post-World War II growth in the absolute and relative importance of Federal grants-in-aid to State and local governments. Such growth is evident in the data which show that Federal spending for grants-in-aid to State and local governments amounted to less than $1 billion in 1946, but increased to $3.1 billion in 1955 and to $14.6 billion in 1967.

Conditional grants-in-aid of the Federal Government ordinarily follow formulas for allocation which have been provided by the controlling statutes. Specifically, the formulas are based on such criteria as income per capita, geographical area, and population. In addition, the sharing formulas are usually guided by either the actual amount of revenue collected in each State, or for the purpose of returning relatively greater amounts of revenue to the poorer States. The latter approach recognizes "need" and the desirability of supplementing revenue-gathering ability at the State and local levels of government. Obviously, the recognition-of-need approach can yield substantial effects on the distribution of income and wealth in the society.

State governments often provide shared taxes to local units of government. Some of these are provided on a strings-attached basis and others on an unconditional basis. The general sales, gasoline, and

excise taxes are the mostly commonly shared State taxes, though in a few States income and death taxes are shared with local governments. Such sharing contributes to administrative efficiency by avoiding duplicate enforcement efforts and by placing the enforcement responsibility in the higher level of government which has a comparative advantage in such matters.[6] Another advantage of State-local shared taxes is the discouragement of economically irrational local government budgetary competition for the attraction of industry.

Though conditionally shared revenues are more prominently used within the U.S. public sector than are unconditional (bloc) grants, recent developments suggest a possible bright future for the latter tax-sharing approach. In 1964, a special economic task force suggested to President Johnson that an elaborate expansion of the unconditional grant-in-aid approach be undertaken by the Federal Government. The task force was headed by Joseph Pechman. The proposal was consistent with earlier studies by Walter Heller, who was Chairman of the Council of Economic Advisers at the time of the Pechman report. This proposal has subsequently been termed the "Heller plan."[7] Moreover, bipartisan political interest in this form of tax sharing was indicated in April 1966, when the Republican National Committee recommended a similar plan.

The Heller-Pechman proposal contains several significant features. First, a fixed percentage of Federal personal income tax collections would be set aside for distribution to the States (with the possible distribution of some of these amounts by the States to local units of government). This amount would constitute a separate trust fund equal to 1 percent of all personal income subject to tax. During the 1965 calendar year, this would have amounted to approximately $2.5 billion, which is 1 percent of the approximate Federal income tax base of $250 billion for the year. The money would then be distributed to the States, generally in proportion to their population, but with some adjustments made for the needs of each State. The funds could be used for whatever purposes desired except for possible restriction on road expenditures which are covered by the separate highway grant-in-aid program. The alternate Republican plan would turn over to the States 2 percent of Federal personal and corporation income tax revenues at the present time with the percentage increasing up to 10 percent in 8 years.

The two basic premises of the Heller plan are (1) the recognized *need* of State and local government for additional revenues to meet expanding functional expenditure requirements in such areas as education, health, and welfare and (2) the probable existence of a *Federal budgetary surplus* at full employment under the present Federal tax structure.[8] The proposal does not suggest a reduction in the absolute amount of conditional grants-in-aid nor in their relative dominance in

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[6] In some instances, however, shared State-local death and automotive license taxes are administered by local government.

[7] Among the excellent discussions of the Heller plan are: Alan L. Otten and Charles B. Seib, "No-Strings Aid for the States?" *Reporter* (Jan. 28, 1965), pp. 33–35; "No-Strings Federal Aid Finds Backers at Forum," *Business Week* (Apr. 3, 1965), pp. 28–29; Edwin L. Dale, Jr., "Subsidizing the States," *New Republic* (Nov. 28, 1964), pp. 11–12; Christopher Jencks, "Why Bail Out the States?," *New Republic* (Dec. 12, 1964), pp. 8–10; and Harvey E. Brazer, "Our Hard-Pressed State and Local Governments," *Challenge* (January–February 1966), pp. 6–9, 41.

[8] This potential surplus refers to the Federal revenue structure as it existed *after* the income tax reductions of 1964. During 1966, however, the full-employment economy of the Nation was not providing a budget surplus. This fact is apparently explained by (1) the Federal excise tax reductions which were subsequent to the Pechman report and (2) intensified Vietnamese war spending since the report was submitted in 1964.

the overall Federal aid programs. During 1965, for example, the $2.5 billion of unconditional grants would have been less than 25 percent of the value of conditional Federal grants-in-aid to State and local governments.

The reasoning behind the Heller plan, which derives from the basic premises cited above, may now be considered. It is estimated that the national economy would provide a $6 billion surplus at full employment during 1965 under the present Federal tax structure. In order to avoid a "drag" or depressive effect upon the economy, Federal budgetary revision would be required. Among the alternative policies of revision are: (1) reduce "progressive" Federal income tax rates and return the surplus to the private sector; (2) reduce regressive Federal excise taxes and return the surplus to the private sector; (3) retain the surplus within the Federal component of the public sector and use it to meet expanded Federal spending; (4) adopt the *Heller plan* and distribute the surplus to State and local governments with no strings attached; (5) adopt some combination of the above alternatives.[9]

Alternative (1), the reduction of Federal income taxes, represents the extreme conservative position while alternative (3), the increase in Federal spending, represents the extreme liberal position.[10] Alternative (2) represents an approach leaning toward the conservative position while the Heller plan itself, and alternative (5), represent compromise positions. The Heller plan avoids antagonism of the extreme liberals by maintaining the same relative importance for the public sector. Furthermore, it avoids antagonism of the extreme conservatives by opposing expansion of Federal spending. In fact, what appears to be a likely course of legislative action, if the Heller plan is eventually accepted by Congress, is to combine it with alternative (2)—thus effectively making alternative (5) the prevailing course of action. In a sense, this was partly accomplished through the Federal excise tax reductions of 1965.

In 1965, Congress reduced Federal excise tax rates on some economic goods and eliminated the tax on many others. The total revenue reduction amounted to approximately $4.8 billion, an amount equal to about 80 percent of the potential full-employment surplus for the year. This will quite possibly be followed in later years by an adoption of the unconditional grant concept of the Heller plan to absorb the remaining potential surplus as well as any additional surplus which could be expected to come about due to the growing productive base of the economy.

Proponents of the Heller plan say that it is a "pleasant compromise" in that (1) the Federal Government does not expand within the public sector (thus satisfying conservatives), (2) that the public sector still continues to operate at the same absolute level (thus satisfying liberals), while (3) severe functional expenditure needs such as education, health, and welfare can be met by State and local governments under the plan. *Opponents* argue that (1) State-local government is not "forward-looking," (2) that it is full of graft, and (3) that it is unduly

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[9] In these proposals, the surplus referred to is potential, not actual. It exists only in the sense that full employment (with its surplus) cannot be attained unless the Federal budgetary structure is *first altered* to make the budget more expansionary in nature. See also the discussion of the full-employment budget concept in ch. 19.

[10] The author admits that use of the terms "conservative" and "liberal" involves semantical problems. It is hoped, however, that the general discussion below will be clear without the time-consuming efforts required for a precise distinction.

subject to influence by pressure groups. They doubt that the functional needs mentioned above would receive appropriate amounts of the money distributed, with no strings attached, from the Federal Government to the lower levels of government. The groups opposing the Heller plan include not only those who lack confidence in the fiscal efficiency of State and local government but also some extreme liberals and conservatives who refuse to accept a compromise position.

In terms of fiscal rationality, the Heller plan provides mixed results. The plan appears to be neutral, for the most part, within the stabilization and growth objectives of public finance. Admittedly, if State governments used the distributed revenues to reduce debt instead of to increase spending, some deflationary results might occur. The bulk of economic effects which would derive from he Heller plan, however, appear to fall within the allocation and distribution branches of public finance. Unconditional grants-in-aid, for example, enlarge the ability of lower levels of government to make expenditure decisions. To the extent that lower levels of government may approximate *quid pro quo* type market decisions better than Central Government, allocation efficiency would thus be enhanced by the unconditional grant-in-aid approach. Moreover, community preferences in the United States, from an individual freedom standpoint, have traditionally been sympathetic to fiscal decision making by lower levels of government.

The allocation dimension which is most influenced by unconditional tax sharing is that which divides allocation among the various levels of the public sector (vertical intergovernmental fiscal relations). Any reallocation of revenue-expenditure patterns among levels of government which may result from adoption of an extensive Federal unconditional grant-in-aid program could either increase or decrease fiscal rationality. No single determinate result applicable to all cases can be predicted. It is important to recognize, however, that such an important allocation dimension would be affected by the adoption of the Heller plan which would significantly extend such grants.

Distribution, of course, is closely intertwined with allocation. Shifts in allocation necessarily redistribute income and wealth in a "living standard" or "real income" sense. A given (ex ante) state of distribution, moreover, is prerequisite to the actual allocation and real income distribution which takes place. These important facts were emphasized in chapters 4 and 5. In conclusion, it should be observed that interrelated allocation and distribution effects would inevitably result from the adoption of the Heller plan. The exact nature of these effects is not determinate because of the influence of secondary variables. Each potential allocative and distributive effect would have to be analyzed on the basis of its individual characteristics.

Tax Supplements

The *tax supplement* technique of intergovernmental fiscal coordination involves the application of separate tax rates to the same tax base by different levels of government. The higher level of government usually imposes the basic tax. This technique is used moderately between the Federal and State levels of government but is used rather extensively between the State and local levels of government. The best example of its present use between Federal and State Government is the income tax of the State of Alaska. This tax adopts the Federal

income tax base and merely collects a fixed percentage of an individual's Federal income tax payment. State and local governments using a combined tax supplement approach ordinarily add the local tax rate to the State tax rate. The general sales tax provides an excellent example of the tax supplement device being used by the State and local levels of Government. The receipts of both the State and local sales taxes are collected by the State government. They are then allocated to local government on the basis of the geographical origin of the tax revenues. Local governments traditionally collect property tax revenues, however, when both State and local governments impose taxes on the same property tax base.

The tax supplement device appears to have little direct influence upon the distributon, stabilization, and economic growth branches of public finance. In terms of technical allocation efficiency, however, enforcement savings in the form of reduced tax collection costs accrue to both the public sector and to the taxpayer who prepares tax returns. Allocative irrationality could be reduced, moreover, if all States used the same tax supplement arrangement for a Federal tax because interstate budgetary competition for industrial and residential location would be reduced. Such uniformity, however, should not be obtained for *all* types of taxes since the characteristics of State resource bases differ so greatly between States. Thus, an allocative disadvantage would result from the tax supplement device if the lower level of government is compelled to accept the revenue structure of the higher level of government imposing the tax even though its "resource base" (which determines its taxpaying base) differs greatly from that of the higher level of government. This circumstance would cause irrational allocation of resources among the various levels of government.

Tax Credits

Under the *tax credit* technique of intergovernmental revenue coordination, one level or unit of government allows an offset for taxes paid to another governmental jurisdiction. Credits for taxes paid to other jurisdictions differ from deductions in that the latter *reduce tax liabilities* to the individual while tax credits usually do not alter liabilities. For example, the crediting devise merely allows a taxpayer to pay Federal taxes with State tax receipts. Deductions, moreover, do not provide the same strong motive for tax uniformity among various units of government at the lower level of government that tax credits provide. This uniformity is more adaptable to the fiscal structure of a unitary political system than that of a Federal system since the latter involves dual autonomy which discourages the imposition of decisions by one level of government upon another. It is possible, however, to use tax credits on an intralevel basis without violating the philosophy of a federal system of government, but this is not the usual nor the most efficient use of the credit device.

In the United States, the Federal Government used the tax credit device as early as 1918 to minimize the multiple international taxation of incomes. In 1924, the Federal estate tax was introduced for the purpose of discouraging the interstate competition for wealth location based on competitive State death tax rates. The Federal Government extended its usage of the tax credit device in 1936 through the introduction of the unemployment insurance program payroll tax

credit. In this instance, the States were placed under virtual economic compulsion to adopt payroll taxes which would be part of the planned Federal-State program. The Federal unemployment insurance tax of 3.1 percent on wages (as appropriately defined) allows a 2.7 percent credit (nearly 90 percent) if paid under a State unemployment insurance tax. Thus, any State not imposing such a tax would lose substantial revenues from its boundaries which otherwise could be retained. All States subsequently passed such a tax. It has been recently suggested that an approach similar to that for the unemployment insurance credit be adopted for the personal income tax in order to encourage all States to use this revenue source and, in addition, to encourage more uniform personal income taxes among the various States; that is, uniform up to the value of the proposed Federal income tax credit.

The tax credit device has been used in a limited manner between local units of government and between the State and local levels of government. One example of the former use is found where county and city sales taxes are imposed in such a manner that the county must allow credit for sales taxes paid to the cities. This places an aggregate limit on the combined county and city sales taxes. California and Utah apply this technique. In addition, a rationality case might be established at the State-local level for limiting local sales tax rates to the amount of the credit allowed by a State in order to discourage intercommunity tax rate competition.

Tax credits have little *direct* influence upon the distribution, stabilization, and economic growth branches of public finance, but the application of this intergovernmental coordination device could have significant indirect influence on stabilization and growth. This would result if the Federal Government used the tax credit device to encourage the States to adopt revenue structures, primarily based upon income taxes, which would be contracyclical in nature and thus serve as automatic stabilizers. Tax credits can directly influence allocation by affecting the intrapublic sector division of allocative efforts between levels of government. To a lesser extent, they may also influence the division of allocation between governmental units at the same level. Moreover, tax credits can affect (improve) technical allocation efficiency by discouraging intergovernmental fiscal competition. They do *not*, however, eliminate duplicate enforcement efforts. Furthermore, tax credits would harm fiscal rationality if the argument is valid which says that lower levels of government approximate the efficiency of market decision making better than do higher levels. This would be true because the tax credit approach transfers revenue decision making to the higher level of government.[11]

During 1966 the Advisory Commission on Intergovernmental Relations, a special commission created by Congress in 1959, recommended extensive Federal Government use of the tax credit device to encourage State government usage of the personal income tax. Fourteen States, for example, do not use the personal income tax though *all* States are under considerable pressure to find adequate revenue sources. More-

[11] The argument of efficient market decisionmaking requires an assumption of long-run general equilibrium and other unrealistic assumptions in a society of purely competitive industries. See ch. 2 in this regard.

over, a majority of the States which do impose the tax apply it at "low" to "moderate" rates. The Commission suggests the adoption of a high Federal income tax credit (such as 40 percent) for State income taxes paid, which amount would then be subtracted from the total Federal income tax liability of the taxpayer. It is argued that a State would thus be able to collect additional personal income tax revenues to the amount of the tax credit without increasing the tax liabilities of its taxpayers.

A 40-percent credit would be worth more than the present deduction for State income taxes paid to taxpayers with taxable incomes up to $50,000. Under the plan, however, those taxpayers with incomes above $50,000 would be allowed the option of continuing to deduct their State income tax payments. It is estimated that the revenue loss to the Federal Government from the plan would not be very large—approximately $700 million annually at the present rate levels of State personal income taxes—and would not exceed $2 billion even if all 50 States imposed a moderately high personal income tax. Pechman does not agree that the tax credit approach is superior to the Heller plan (discussed earlier in the chapter).[12] He points out, for example, that the tax credit device would assist the wealthier States the most, in absolute terms, and the poorest States the least.[13] Furthermore, it may be politically difficult to obtain State personal income taxes in those States where they are forbidden by the State constitution.

Tax Deductions

The *tax deduction* approach to intergovernmental fiscal coordination is used between all levels of the public sector. The most significant use of tax deductions involves the various deductions from the Federal personal income tax for such taxes as income, general sales, use, personal property, and gasoline taxes paid to other jurisdictions. These deductions are subtracted from adjusted gross income. Many State income tax structures, moreover, allow deductions for the Federal income tax. In addition, some States also allow deductions for certain excise taxes.

The tax deduction approach exerts no direct influence upon the stabilization and growth branches of public finance, though it may exert indirect effects through its influence upon consumption, work, and investment incentives. Certain direct effects, however, flow from the tax deduction technique to the allocation and distribution branches. For example, consumption patterns would be distorted if excise taxes on some economic goods are deductible while other specific excise taxes are not deductible. In addition, allocation will be influenced as the revenue source pattern between units and levels of government is altered. The higher level of government is able to influence the tax structure adopted by the lower level through this device. Yet, the influence is much less severe than it is with the tax credit approach. Finally, it appears that tax deductibility may serve the distribution objective of fiscal equity in a positive manner by reducing multiple taxation.

[12] Pechman, *op. cit.*, p. 41.
[13] *Ibid.*

Federal-State Tax Immunities

Intergovernmental *tax immunities* are not spelled out clearly in the Constitution. Instead, they have developed over the years through the judiciary process. At times they have constituted a significant point of controversy between the Federal and State levels of government. The practice of both Federal and State Governments' exempting certain of each other's instrumentalities from taxation was initiated by the famous *McCulloch* v. *Maryland* case in 1819. The practice expanded throughout the remainder of the 19th century, but some narrowing of immunities has occurred during the 20th century.

The principal immunities at the present time are: (1) the "mutual" income tax exemption of interest on Federal and State Government debt obligations and (2) the exemption of properties of the Federal Government from certain State and local government property taxes. Some minor exceptions exist regarding the latter; namely, (1) a certain small amount of Federal property is subject to taxation in the manner of private property, (2) in some cases, payments are made in lieu of property tax payments to State and local government, and (3) the Federal Government, on occasion, shares the revenue derived from its property with State and local government.

Regarding rationality, it appears that immunities on State and local government securities by the Federal Government, and vice versa, can distort allocation efficiency in a rather severe manner by diverting investment funds away from the corporate security market. The growing use of industrial development bonds, moreover, suggests rather serious questions regarding fiscal rationality. Such bonds are typically issued by local governmental units to finance projects aimed at the encouragement of business firms to locate within their political jurisdictions. Such arrangements, of course, are subsidies to the business firms involved. In some cases, a local government issues bonds to finance plant construction, the bonds being sold to the same firm which subsequently purchases or leases the plant. Meanwhile, the firm receives tax-exempt interest income. Conventional financing and plant location economics are indeed threatened with distortion by these practices.

Administrative Cooperation Between Levels and Units of Government

Congressional and executive endorsement by the Federal Government of administrative cooperation between Federal and State tax administrations has existed for more than a generation. Such cooperation has been rather limited in practice, however, and has consisted mostly of the exchange of income tax information. In some cases, it has amounted to a one-way flow of Federal information to the States, though the trend is toward improvement and the Internal Revenue Service now has formal agreements with 41 States for the exchange of tax information.

Among the important considerations in developing a higher degree of administrative cooperation on a vertical basis between levels of government on fiscal matters is the significant fact that the basic tax col-

lection technique used within the public sector of the United States is that of *voluntary compliance* on the part of taxpayers. Administrative efficiency through intergovernmental cooperation is thus desirable for the encouragement of accuracy in compliance and for subsequent enforcement equity. The Internal Revenue Service reports that $10.6 million in additional Federal revenue could be directly attributed in fiscal 1960 to information provided by State governments.[14] Undoubtedly, the gain to the States from the Federal Government was also of considerable magnitude. Furthermore, the indirect revenue benefits which derive from the taxpayer's knowledge that more efficient enforcement efforts are being undertaken will help both levels of government. Meanwhile, certain nations such as Australia, Canada, Norway, and West Germany have attained a high degree of cooperation in tax administration between their central governments and lower levels of government. On a horizontal intralevel basis, some States governments exchange information on the income of corporations which operate in more than one State. This is for the purpose of more effectively enforcing State corporation income taxes.

TECHNIQUES OF FISCAL POLICY*

The Surplus Budget

When the Federal Government collects more in taxes than it spends, the resulting surplus may be utilized in a variety of ways. An increase in tax rates and/or a reduction in government spending may lead to a surplus budget. Depending upon the particular surplus disposal technique selected, the contractionary effect of the surplus budget working through a negative multiplier may be either reinforced or neutralized. If maximum economic contraction is desired, the surplus funds should be held idle and not allowed to reenter the private sector. Under such conditions, no neutralization to the negative multiplier occurs since a net decrease in private sector purchasing power has taken place. On the other hand, if some degree of neutralization is desired the surplus can be (1) distributed among groups who will spend most of it immediately, which would yield a substantial offset to the contractionary effects of the surplus, or (2) the surplus can be used to retire already existing government debt. In the latter case, depending upon who holds the debt that is to be retired, varying degrees of partial neutralization will result.

The disposal of a surplus, in addition to influencing the degree of multiplier-cause contraction, may also exert significant allocation and distribution effects depending upon the pattern of surplus disposal which is selected. The allocation effects consist of resource pattern changes both *between* the public and private sectors and *within* each sector. Table 18–2 summarizes some of the more significant allocation and distribution results which derive from alternate procedures of disposing of a Federal surplus.

[14] Advisory Commission on Intergovernmental Relations, *Intergovernmental Cooperation in Tax Administration* (Washington, D.C.: June 1961), p. 7.

*Chapter 18.

TABLE 18-2.—*Allocation and distribution effects of alternative surplus disposal techniques*

6 alternatives	Federal tax effect	Overall tax burden effect	Effectiveness of plan from a State and local standpoint	Intergovernmental relations effect
Compensatory fiscal approach: Cut Federal income tax or reduce the national debt or both depending on economic conditions.	Federal income taxpayers could expect further reductions in tax liability.	The overall Federal-State-local tax system would be less progressive because the Nation would be required to place increasing reliance on proportional and regressive State and local taxes to finance rising domestic needs.	Least efficient because direct benefits accrue to individual Federal income taxpayers—indirect benefit to the extent that a compensatory fiscal policy promotes greater economic activity and expands the State and local tax base. Can affect willingness to raise State and local taxes either way.	Federal role somewhat diminished by the relinquishment of effective control of part of its fiscal resources and State and local government roles commensurately enhanced.
Tax credit option approach: Provide Federal income taxpayers a more generous writeoff of their State and local taxes with an option plan permitting them either to itemize their State and local tax payments (as they can do now) or receive a tax credit for State and local tax payments in excess of — percent of their net taxable income.	Persons in the low and middle tax brackets carrying above average State and local taxloads would receive the most benefit. Persons in the high tax brackets now enjoy a liberal writeoff privilege through itemization.	The overall effect slightly more progressive because (*a*) low and middle income tax bracket taxpayers receive larger writeoffs and (*b*) State and local governments would be encouraged to place more reliance on income taxes in order to maximize tax credit possibilities.	More efficient than outright tax cut only to extent that tax credits overcome resistance to higher State and local tax rates. Much less efficient than sharing or grant approaches because direct aid is to taxpayers rather than to governments.	Federal role somewhat diminished—State and local governments somewhat enhanced because a more liberal writeoff of State and local taxes could help to overcome resistance to higher State and local taxes.
Tax sharing approach: Distribute to the States a designated percentage of the	None	No marked change in the tax incidence picture unless Fed-	An efficient aid mechanism because States are left free to	Federal role diminished: States' role enhanced because these

Federal tax revenue on the basis of collection.		eral dollars actually replace State and local revenue sources. In that case, there is a slight progressive effect.	allocate the funds among competing needs. Local governments' benefit dependent on how they share in the funds.	governments determine how funds would be spent.
Unconditional grant approach: Through a permanent trust fund, distribute among the States for general Government purposes, on a per capita basis, an amount equal to 1 or 2 percent of the Federal income tax base (proposal of President's Task Force on Intergovernmental Fiscal Cooperation).	-----do.------	-----do.------	-----do.------	Do.
Conditional grant approach: Expand present type of conditional grant-in-aid programs to finance special functions.	-----do.------	No marked change in the tax incidence picture unless need for State and local matching funds requires increases in regressive type taxes.	A fairly efficient aid mechanism. Both State and local governments are directly benefited but because of their specific expenditure focus, conditional grants tend to distort allocation of funds among programs.	Federal role definitely enhanced in relation to State and local governments.
Direct Federal expenditure approach: Step up direct Federal expenditure for such programs as river and harbor construction projects; or launch new programs to deal with domestic problems of an interstate character, such as air pollution and mass transportation.	-----do.------	No marked change in the tax incidence picture. Distribution of benefits for construction type project likely to be less favorable to low-income groups than expenditures on social purposes.	An indirect aid to the extent that direct Federal activity relieves State and local governments of the responsibility for financing the program. Far less effective than tax sharing or grant approaches.	Do.

Source: Advisory Commission on Intergovernmental Relations.

Thus, it is observed that not only do unbalanced budgets provide primary multiplier effects through tax rate and spending changes, but also that important secondary economic effects may result depending upon the particular technique used to finance a deficit or to dispose of a surplus. The specific technique selected, however, will necessarily depend upon policy objectives and upon the overall conditions of the economy. The huge Federal deficits of World War II were inevitable, for example, and the proper fiscal policy under these conditions—a surplus budget—could not be used despite the inflationary gap conditions which prevailed. The next best approach was to finance the deficit in the most restrictive way possible in terms of secondary effects. Consequently, an enormous effort was made to sell war bonds to the private sector of the economy as well as to the banking system, while at the same time monetary policy attempted generally to restrict private credit. It is seen in this example that fiscal and monetary policy cannot be totally divorced from each other. Instead, they require coordination to achieve mutual economic objectives. It is perhaps noteworthy, in terms of improved future policy, to observe that the institutional arrangement for monetary policy working through the "quasi-independent" Federal Reserve System is considerably different from the institutional arrangement for fiscal policy which works "slowly" through the government budget as requested by the executive branch of government but as implemented through the legislative actions of Congress. The relationship between fiscal policy and monetary policy will be explored further in the following chapter, which analyzes the various fiscal policy norms or benchmarks and their monetary policy alternatives.

Part 2

REVENUE SHARING WITH STATES AND LOCAL GOVERNMENTS

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*For "Federal Tax Sharing, etc.," first article in Section A.

Section A: POSSIBILITIES AND PROBLEMS

FEDERAL TAX SHARING: HISTORICAL DEVELOPMENT AND ARGUMENTS FOR AND AGAINST RECENT PROPOSALS

BY MAUREEN MCBREEN*

INTRODUCTION

There has been considerable agitation during the past 3 years for enactment of legislation which will channel some portion of Federal tax revenues to State and local governments with a minimum of Federal supervision and control.

This idea of Federal tax sharing with State and local governments actually is not new, but it has only recently received widespread public attention.

TAX SHARING ADVOCATED BY THE DEMOCRATIC ADMINISTRATION

One of the leading proponents of such a proposal has been Dr. Walter W. Heller, former Chairman of the President's Council of Economic Advisers. In June 1960, while still chairman of the Economics Department of the University of Minnesota, he proposed that rising Federal revenues be distributed to State and local governments with few or no string attached.[1]

This proposal did not begin to receive serious consideration until the spring of 1964. Earlier in the year, the Revenue Act of 1964 had been signed into law, and administration leaders were hopeful that the substantial reductions in income tax rates provided by this law would give the American economy the additional stimulus which was needed to enable it to operate at close to maximum productive capacity. At that time, the prospects of achieving Federal budgetary surpluses in the next few years appeared quite hopeful, and it was felt that serious attention could now be focused on this tax-sharing proposal as a means of alleviating the financial plight of many State and local governments.

The Democratic Party platform adopted in the summer of 1964 specifically recommended that the Federal Government should give consideration to the "development of fiscal policies which would provide revenue sources to hard-pressed State and local governments to assist them with their responsibilities."

During the election campaign which followed during the fall of 1964, both presidential nominees voiced their general support of this

*Analyst in Taxation and Fiscal Policy, Economics Division, Legislative Reference Service, The Library of Congress, Washington, D.C. Jan. 30, 1967.

[1] For a detailed description of Dr. Heller's proposal, see p. 718 ff.

proposal. President Johnson declared the intention of the administration to carry out the pledge the Democratic Party had made to seek ways and means of providing additional financial assistance to State and local governments. As a means of carrying out this intention he proposed that the Federal Government make available to State and local governments "some part of our great and growing Federal tax revenues—over and above existing aids." [2] The Republician nominee, Barry Goldwater, recommended that a portion of Federal income taxes be returned to the States, and that State governments be given a larger share of revenues derived from inheritance taxes.

Presidential Task Force Studies Proposal

President Johnson then appointed a task force composed of individuals from government and business and headed by Dr. Joseph A. Pechman, Director of Economics at the Brookings Institution, to study the possibility of setting aside a fixed percentage of Federal revenues each year in a trust fund for distribution to State and local governments. A report was subsequently made by this task force and submitted to the White House, but the full details of its recommendations were never made public.

Two basic considerations prompted the Democratic administration to consider in 1964 the possibility of sharing additional Federal revenues with State and local governments over and above assistance already available under existing Federal grants-in-aid.

First of all, the steady growth of the gross national product and the expectation of a continued upsurge in our economy led many optimistically to predict that by 1966, and in the years immediately following, a Federal budgetary surplus would be achieved. While these surpluses were to be welcomed, there was some apprehension among administration economists that the realization of these surpluses before full employment of manpower and resources was achieved would cause a "fiscal drag" on our economy and would retard the business expansion which was underway.

The second underlying factor was the general widespread belief that State and local governments were badly in need of new revenue sources to meet the ever-growing requirements of their rapidly expanding population for additional schools, hospitals, and health and welfare services. With tax systems which place heavy reliance on sales taxes, fees, and property taxes rather than taxes on incomes, State and local governments are finding it increasingly difficult with each passing year to find adequate revenues to finance the rising costs of these programs considered vital to the well being of their citizens.

While, as noted above, the findings of the Presidential task force have never been officially released, it is understood that a formula was recommended which would provide that 1 or 2 percent of the Federal personal income tax base (which is taxable income after exemptions and deductions) would be set aside annually in a trust fund for distribution to State and local governments. Thus, assuming, for example, a tax base of $250 billion, State and local governments would

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[2] Presidential Statement No. 6 On Economic Issues. *Strengthening State-Local Government,* Oct. 28, 1964.

receive anywhere from $2.5 to $5 billion annually should such a formula be adopted. As the economy expanded and Federal revenues rose, more would automatically become available for allocation to State and local governments under this plan.

Supposedly these block grants were to be given to the States unconditionally. This means that State and local governments would be free to make their own determination on just how the money would be spent. Also, there would be a minimum of Federal supervision over the expenditure of these funds once they were disbursed to the States.

It is reported that the task force recommended that perhaps a relatively small proportion of the total payments be distributed on the basis of per capita income and the remainder on a population basis.

These amounts would be in addition to payments which are already made under the many existing programs of Federal aid, some of which have been in operation for years. During the current fiscal year, 1967, such payments to State and local governments are expected to amount to $15.4 billion. They are disbursed for specific purposes such as for highway construction, airport construction, school construction and maintenance, public assistance and for a wide variety of welfare-related programs. They are allocated under varying formulas prescribed by law. These formulas frequently require State matching, and many have been so devised that the poorer States receive relatively more aid than the richer States. Each program is subject to close supervision and control by the administering Federal agency. During the fiscal year 1966 Federal grants-in-aid constituted 15.6 percent of State and local government revenue.

Historical Precedent for Federal Tax Sharing

A. United States Experience

As is noted above, Federal revenue sharing with State and local governments is not new. For many years the U.S. Government has shared some percentage of revenues derived from the sale of Federal public lands, from grazing leases and permits, from the use of national grasslands, and so forth, with State and local government. In some instances no specific purpose is prescribed by law on the use of these shared revenues; in others, they are restricted to use for specified purposes, such as public education, roads or other internal improvements.

One historic precedent for the distribution of Federal surplus funds among the States on an unconditional basis was the Surplus Distribution Act of 1836. During the administration of President Andrew Jackson, a large Federal surplus had accumulated as a result of substantial revenues received from the sale of public lands and from customs receipts derived from an expanding foreign trade. The public debt had been virtually eliminated, and so this legislation was enacted which provided that all money in the Treasury on January 1, 1837, with the exception of $5 million, should be deposited with the States in proportion to their respective representation in the Senate and in the House of Representatives. These deposits were to be made in four installments—on January 1, April 1, July 1, and October 1. In return

for these deposits the Secretary of the Treasury received certificates from the States which pledged that they would keep and repay the money as might be required by the Secretary of the Treasury from time to time.

Of the $37 million available for distribution, $28 million was actually deposited with the States in three installments. A financial crisis arose during the latter half of 1837, and the fourth installment was never made. Although these funds were extended only as a loan, which was subject to repayment, actually the distribution was generally considered as an outright gift, and none of the money was ever requested or returned. This act did not specify what use the States might make of these funds, but a large number of the States spent some portion of their allotment for educational purposes. Others used the money to pay current expenses, to reduce State indebtedness, to build roads, bridges, canals, or to make other internal improvements. The State of Maine made a per capita distribution of its share of the money received.

At the State and local level, the sharing of State tax revenues with local units is a common and widespread practice.

B. FOREIGN EXPERIENCE

Canada, Australia, Western Germany and Argentina have varying arrangements of sharing tax revenues with local governing bodies.

Present Administration Stand on Tax Sharing

The Democratic administration has now shelved, at least for the time being, this proposal for Federal tax sharing with State and local governments. Undoubtedly, the fiscal impact of acceleration of the war in Vietnam has been a primary factor in influencing the President to postpone making any specific legislative recommendation for adoption of some form of Federal tax sharing. Further, the administration prefers to rely on established programs of grants-in-aid. There is, reportedly, strong opposition within Government to such a proposal which would allocate Federal funds to political units with little or no strings attached. President Johnson, in his state of the Union message delivered at the convening of the 90th Congress on January 10, 1967, emphasized the extensive Federal assistance which is already being provided to State and local governments. He reported that "during the past 3 years we have returned to State and local governments about $40 billion in Federal aid. This year alone, 70 percent of our Federal expenditures for domestic social programs will be distributed by State and local governments."

The Heller Proposal

Dr. Heller, in his latest book, *New Dimensions of Political Economy*,[3] spells out in detail his Federal tax-sharing proposal. In essence, he would set aside in a trust fund 1 to 2 percent of the Federal individual income tax base (the amount reported as net taxable income

[3] Heller, Walter W. *New Dimensions of Political Economy*. The Godkin lectures at Harvard University. Cambridge, Mass., Harvard University Press, 1966. 203 pages.

by individuals). He estimates that a 2-percent rate applied to the 1966 tax base would yield some $5.6 billion for the State and local governments.

He believes that taxable income is superior to actual income taxes collected in determining the amount set aside for distribution to the States. He offers the following reasons for this opinion:

First, taxable income is somewhat more stable than revenues. Second, since the States' share would be independent of the level and structure of Federal rates, this approach would not create a vested interest in a particular set of rates (though it might do so in exemption levels). Third, for the same reason, it is less likely to interfere with Federal use of the income tax in stabilization policy than a plan keyed to income tax revenues.[4]

His plan would call for a per capita sharing among the States of the amounts set aside in this trust fund. A per capita distribution was deemed preferable to sharing on the basis of origin of tax collections as the former would allocate the funds more on the basis of need, whereas the latter would return more to the higher-income, higher revenue-producing States and correspondingly less to the poorer States.

He also recommended that if a greater measure of fiscal equalization is deemed advisable than would be available by using only a per capita distribution, then perhaps from 10 to 20 percent of the total amount might be allocated on the basis of per capita income.

A trust fund was suggested as it would make the funds available to the States "as a matter of right, free from the uncertainties and hazards of the annual appropriation process."[5] This device, he felt, would also be less apt to infringe on the flow of grants-in-aid.

These block grants would be over and above amounts already received by State and local governments under the many existing Federal grant-in-aid programs. Furthermore, they would be available automatically from year to year and would not be contingent on the realization of a Federal budgetary surplus. In this way State and local governments would have a continuing and a dependable source of income and could plan their programs without fear that this revenue source might suddenly be withdrawn.

Dr. Heller advocates that the States be given almost complete freedom in the use of these funds. He does ask, however, that the States meet the usual standards required in accounting, auditing, and reporting the expenditure of public money. He further stressed the importance of using the revenues shared in such a way as not to violate title VI of the Civil Rights Act of 1964 which prohibits racial discrimination in federally financed programs. He indicated that it might be deemed advisable to restrict expenditure of these grants to education, welfare and community development programs, or at least, to prohibit their use for highway purposes.

Dr. Heller has not proposed that his plan be put into effect immediately, but he has urged that a plan be fully developed and put into action just as soon as the Vietnamese conflict is resolved.

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[4] *Ibid.*, p. 146.
[5] Heller. *Op. cit.*, p. 146.

Criticism of the Heller Proposal

Proponents of other Federal tax-sharing plans have voiced the following criticisms to Dr. Heller's proposal. Some feel that a greater degree of fiscal equalization should be provided than just allocating the funds on the basis of population. The trust fund device has been criticized as being inflexible and would prevent Congress from annually reviewing and giving proper surveillance to such a program. It is also felt that it lacks provision for gradually increasing the percentage of revenues which might be returned to the States over a period of time. Other believe that more Federal controls should be exercised over the distribution of these shared revenues and that more incentive should be included in such a plan for the reform of State and local governments. As Representative Henry S. Reuss has expressed it: "It encourages State and local governments to languish in archaic inefficiency rather than to demonstrate their initiative and thus could result in pouring Federal money down a rathole."[6] Finally, local authorities feel that it is weak since it makes no provision for distribution of the funds below the State level.

Republican Party Position on Federal Tax Sharing

While the Democratic administration is not at this time supporting this proposal, the Republican Party has made it one of its key issues and many of its spokesmen indicate that they intend to press vigorously for some form of Federal tax-sharing legisliation during the 90th Congress.

The Republican Party, in submitting its own state of the Union message last year and this year, has recommended a system of Federal tax sharing with State and local governments without Federal controls.

The Ripon Society—a group of liberal and moderate Republicans from universities, business, and professions—has strongly supported this proposal.

A. The Republican Coordinating Committee Proposal

In the spring of 1966, the Republican coordinating committee submitted its own proposal that the Federal Government share some percentage of personal and corporation income tax collections with the States. In its report, *Financing the Future of Federalism: The Case for Revenue Sharing*, the committee recommended that this amount might start at 2 percent during the first year and gradually increase to 10 percent after the eighth year. As spelled out by this committee, under its plan, "one-half of each State's share would be computed on the basis of returning income tax collections to the State in which they originated. The other half of each State's share would be computed in a way which will provide some measure of fiscal equilization."[7] The committee further advocated that this equalizing formula be based upon population and per capita income, but that these equalization grants be given only to those States and local units which are contributing an adequate amount of their tax revenues to meet the costs of

[6] Reuss, Hon. Henry S. *Prometheus Unbound and Unbankrupt: the State and Local Government Modernization Act of 1967*. Washington, D.C., Nov. 25, 1966.

[7] Republican Coordinating Committee. *Financing the Future of Federalism: The Case for Revenue Sharing*. Task Force on the Functions of Federal, State and Local Government. Washington, D.C., March 1966.

their own services. It has also urged that (other than prohibiting use of these funds for promotion of racial discrimination) a minimum of Federal controls be exercised over the States' expenditure of these block grants.

Republican Members of Congress in increasing numbers are stressing the urgency for enactment of Federal tax-sharing legislation with a minimum of Federal controls.

B. THE LAIRD PROPOSAL

Representative Melvin R. Laird, of Wisconsin, chairman of the House Republican Conference, has criticized the grant-in-aid approach as a "second best method of attacking the problems in our society at the Federal level" and proposes tax sharing as the "Great Republican alternative to the Great Planned Society."[8] He is hopeful that legislation will be enacted which will not supplement but which will eventually supplant many of the existing categorical grant-in-aid programs. As far back as 1958, he introduced Federal tax-sharing legislation. Early in the 89th Congress he introduced H.R. 1562 which would return 5 percent of Federal income tax collections to the States from which they were derived with no strings attached. He plans to reintroduce similar legislation in the 90th Congress. He proposes a formula which will equalize the disparity in incomes among the various States. The only Federal standards he would impose would be constitutional ones such as prohibiting use of the money for the promotion of racial discrimination.

C. THE GOODELL PROPOSAL

Representative Charles E. Goodell, of New York, chairman of the Republican Planning and Research Committee of the House of Representatives, has recently proposed that 3 percent (and gradually increasing to 5 percent) of Federal individual income tax revenues be returned to the States. Of the total amount available for distribution to the States, 90 percent would be allocated to the States on a population basis, weighted by an index of tax effort. The remaining 10 percent would be distributed among the 17 States having the lowest per capita personal income. In allotting these funds to an individual State, 50 percent would be available for purposes determined by the State; 45 percent would be turned over to local governments for use as they saw fit; and 5 percent would be available for State executive staff and management improvement purposes. Thus, his proposal seeks not only to make additional Federal assistance available to State governments but also assures local political units that they will receive a significant share of the total State allotment.[9]

Democratic Advocates of Federal Tax Sharing: The Reuss Proposal

Among the Democratic supporters of Federal tax-sharing legislation is Representative Henry S. Reuss of Wisconsin who is planning to introduce a bill early in the 90th Congress providing for the distri-

[8] Laird, Hon. Melvin R. *Tax-Sharing With the States: A Way Out.* Keynote address given before the National Conference of State Legislative Leaders, The Shoreham Hotel, Washington, D.C., Nov. 17, 1966.

[9] Goodell, Hon. Charles E. *A Proposal for General Aid to State and Local Governments Through Sharing of Federal Taxes.* Press Release, Nov. 27, 1966.

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bution of block grants amounting to $5 million annually over a 5-year period to those States which have approved plans for modernizing and revitalizing their State and local governments. These funds would be apportioned on the basis of population with no more than 20 percent of the total amount available as supplements for the poorer States.[10] Thus, Congressman Reuss is seeking not only to give more Federal financial assistance to State and local governments but is also attempting to give these political units additional incentive to modernize their governmental structures which he considers too antiquated and inefficient.

State and Local Advocates of Federal Sharing

State and local officials understandably are strongly urging enactment of a Federal tax-sharing plan as a means of helping to ease their financial burdens. The National Governors' Conference has unanimously endorsed such a proposal, and many mayors and other local officials are advocating prompt action on this matter.

Federal Tax-Sharing Legislation Introduced During the 89th Congress

During the 89th Congress growing interest in this issue was evidenced by the introduction of many tax-sharing bills providing financial assistance to State and local governments. In all, it was found that at least 57 Members of Congress sponsored or cosponsored 51 such bills. Nearly four out of five of these sponsors were Republican Members (45 Republicans as compared with 12 Democrats).

The appendix to this report briefly summarizes each measure which was introduced during the 89th Congress on this subject.

By far the greater number of these bills make provision for Federal tax sharing of a certain percentage of tax collections (primarily income receipts) with the States from which derived. The percentage ranges from one-fourth of 1 percent to 10 percent of the amount of taxes collected.

Some of the bills use taxable income rather than actual tax collection data in determining the amount to be set aside for distribution to the States. S. 2619 introduced by Senator Jacob Javits, Republican, of New York, and others, and nine identical bills introduced in the House of Representatives by Representative Ogden Reid, Republican, of New York, and others more closely resemble Dr. Walter Heller's revenue-sharing proposal.[11] They would establish a trust fund into

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[10] Reuss. *Op. cit.*

[11] Early in the 90th Cong. Senator Javits and Senators Baker, Carlson, Cooper, Dominick, Scott, and Young of North Dakota introduced a modified version of S. 2619. This new bill—S. 482—would appropriate to a revenue sharing fund in the U.S. Treasury a percentage of aggregate taxable income reported on individual income tax returns beginning with 1 percent in fiscal year 1968, 1½ percent in fiscal year 1969 and 2 percent in fiscal year 1970 and thereafter. Eighty-five percent of this fund would be available for distribution to the 50 States and the District of Columbia on the basis of population and the State's revenue effort ratio. The remaining 15 percent would be allotted to those States which have a per capita personal income which is lower than the national average. These funds are to be available for use by the States for health, education, and welfare purposes. In addition, no more than 5 percent of the total amount allotted to any State may be used for "planning, research, and development in the fields of modernization of the institutions of State government and the improvement of governmental procedures" (sec. 4(a)). Provision is also made in this bill for submission to and approval by the Secretary of the Treasury of a plan by the State governors outlining how the funds will be used and how they will be allocated among local governments. Senator Javits estimates that, based on current data, $3 billion would be available for distribution to the States during the first year his bill becomes effective.

which would be deposited 1 percent of aggregate taxable income for distribution to the States for health, education, and welfare purposes. Eighty percent of the total would be distributed on the basis of population plus tax effort of the individual States, and the remaining 20 percent would be allocated to the 13 States with the lowest per capita income.

H.R. 6470 introduced by Representative John Dowdy, Democrat, of Texas, would direct the District Directors of Internal Revenue to retain in State depositories an amount equal to 2 percent of the aggregate income tax liability less credits of all individuals residing in the individual States for use by the States for public education purposes only.

While some of the bills introduced did make definite provision for allocation of the funds to local as well as to the State governments, quite a number of them gave the States full determination in the distribution of the funds within their boundaries. One bill, H.R. 10828, sponsored by Representative Abraham Multer, Democrat, of New York, did provide for payments to be made directly to local rather than to State governments. His bill would rebate one-fourth of 1 percent of total Federal income taxes to the local governments from which derived.

Of the 51 tax-sharing bills identified, 32 provided Federal assistance for educational purposes only; 10 bills would allocate the funds for health, education, and welfare purposes; and one bill, H.R. 12730, would make the money available for law-enforcement purposes. The remaining bills made no specific provision on how the funds were to be used.

Quite a few of the bills limited the Federal controls which could be exercised over State expenditure of these block grants, and contained the wording that the funds were to be used by the States "without any Federal direction, control or interference."

Not included in these 51 bills are two other measures which offer alternative means of providing financial assistance to State and local governments other than by returning a specified percentage of Federal tax receipts. H.R. 17998 introduced by Representative Donald Fraser, Democrat, of Minnesota, would appropriate to a fund in the U.S. Treasury an amount equal to a percentage of State and local tax revenues (ranging from 6 percent in fiscal year 1968 to 25 percent in fiscal year 1978 and thereafter). Payments were authorized to be made on the basis of population to those States which have had a State plan approved for distribution of its share among taxing jurisdictions within its boundaries.

Another bill, H.R. 16269, sponsored by Representative John Culver, Democrat, of Iowa, would provide Federal financial assistance to State and local governments from fiscal year 1968 through 1978 and thereafter in an amount equal to a specified percentage ranging from one-half of 1 percent to 2 percent of the gross national product. Distribution of this fund would also be on the basis of population and would be made to those States which had plans approved for allocation of their share among their local taxing jurisdictions.

Other than having been referred to the appropriate congressional committee for consideration, no action was found to have been taken on any of these measures. Undoubtedly, many of them will be reintroduced during the 90th Congress.

Pro and Con Arguments on Federal Tax Sharing

Some of the basic arguments for and against the proposal that the Federal Government share some portion of its tax revenues with State and local governments with little or no strings attached are summarized below.

A. ARGUMENTS IN FAVOR OF FEDERAL TAX SHARING

The primary argument for Federal tax sharing with State and local governments is the contention that the Federal Government has preempted the major revenue-producing source of income—the income tax. As a consequence, State and local governments have found it necessary to rely primarily on property and sales taxes to finance their programs. While income-tax revenues expand rapidly in response to an overall upsurge in economic activity, receipts from property and sales taxes remain relatively stable and are inadequate to meet the soaring costs of State and local governments. Therefore, it is argued, the Federal Government has an undue advantage over other governmental units, and during an era of economic prosperity it will collect more than it needs to finance its own programs. Hence, part of this excess in collections should be turned back to hard-pressed State and local governments.

When Federal tax sharing began receiving more widespread attention in 1964, it was contended that, in an expanding economy and under existing tax rates, Federal revenues are increasing on the average by about $6 billion per year. Some economists were fearful that once the conflict in South Vietnam is concluded and the level of Federal spending is reduced, additional tax revenues generated by a booming economy would siphon off too much money from the private sector of the economy. A Federal surplus would result before full employment of manpower and resources is achieved. Such a surplus has the effect of retarding economic growth, and in time, the forces of recession set in. It is believed that enactment of this tax-sharing proposal will avert this "fiscal drag" which such budget surpluses may exert upon our national economy.

It is true that appropriate tax reduction measures will also counteract the restrictive effects on the economy that a budget surplus produces. However, tax reduction bills may take too long to enact, and a recession may be well on its way before such legislation can take effect. By making excess revenues automatically available to State and local governments, action gets under way immediately to offset the contractive effect of such surpluses when they do arise.

To the argument advanced that the Federal Government cannot at this time afford such a proposal, some Republican advocates assert that these block grants can evenutally replace categorical grants-in-aid. Hence, adoption of such a plan will not, in the long run, place any additional financial strain upon the Federal purse.

It is argued that the largest areas of unmet national need today lie in the services provided by State and local governments. Latest available statistics on Federal, State, and local finances reveal that State and local government expenditures are climbing at a substantially

faster rate than Federal outlays. During the 10-year period from 1956 to 1965 State and local disbursements for general governmental purposes (current operations, capital outlay, interest on the debt, etc.) more than doubled—from $36.7 to $75 billion, while those of the Federal Government rose by about 60 percent—from $68.8 to $110 billion. State and local government debt increased just as rapidly during this same decade—from $48.9 to $99.5 billion, while Federal debt rose by about 17 percent from $272.8 to $317.9 billion.

All predictions on future State and local government spending indicate that the trend will continue upward rather than downward in the years ahead. Dr. Joseph Pechman has conservatively estimated that by 1970 general expenditures by these governments will rise to about $103 billion, while general revenues (including Federal grants) will only amount to $88 billion—creating a deficit of some $15 billion.[12] Another projection made for the Committee for Economic Development by Dick Netzer estimates that for the same year total State and local revenues will fall short of expenditures by about $10 billion.[13]

In an attempt to meet their obligations, States and municipalities have been active during the past 2 years in increasing their tax levies. But, it is claimed, they have just about reached the saturation point in sales and property taxation, and voters are registering their disapproval at the polls to any further increases in these or in income taxes. While the financial condition of State and local governments has been weakened despite tax increases, the Federal position has been strengthened by the opposite action—by income and excise tax reduction or repeal.

Because of the shortage of funds which has plagued State and local governments in the past, the Federal Government has found it necessary to intervene by means of special grants-in-aid to help alleviate this problem. During the past 10 years direct grants to State and local units have about tripled—from $5.1 billion in the fiscal year 1958 to an estimated $15.4 billion on the current fiscal year, 1967. The 89th Congress enacted much legislation which extended or enlarged existing programs and initiated new ones.

Federal tax sharing would provide State and local governments with an additional and continuing source of revenue upon which they can depend and will relieve in some measure the shortage of funds which constantly faces them. Thus, they will be in a better financial position to provide more schools, hospitals, health and welfare services for their growing population.

Advocates assert that the simplicity of such a proposal makes it all the more desirable. Block grants made to these governing bodies will enable them to operate more independently without burdensome Federal controls. Thus, to a greater extent local officials will be free from Federal domination and red tape involved in meeting the stringent Federal conditions imposed in order to qualify for assistance under existing grants-in-aid. Many programs now administered from Washington could be performed at the State and local level by those officials

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[12] Pechman, Joseph A. *Financing State and Local Government.* Studies in Government Finance. Washington. The Brookings Institution, 1965, p. 76.

[13] According to Dr. Heller, Dick Netzer predicted that by 1970 total State and local expenditures would amount to $121.2 billion and revenues would reach $111.4 billion. See the *Congressional Record* (daily edition), May 24, 1966, pp. A2775–A2776.

who are most familiar with their own particular needs and problems and who can make the wisest allocation of these funds in the interests of their own citizens. Thus, the spread of a growing Federal bureaucracy will be halted.

At the same time, Federal tax sharing without the usual strict controls will relieve Federal officials from additional onerous details now required in administering existing grant-in-aid programs. This would allow them more time and energy to devote to the more pressing problems of maintaining our national security, building better relationships with our allies abroad and meeting the needs of our citizens at home. They would also be freed from constant pressuring from lobbying groups seeking special favors, benefits, or projects for their particular groups or districts.

It may be argued that if these funds are granted that rural-dominated State legislatures may bypass the urgent and growing needs of large metropolitan areas. Dr. Heller believes that the Supreme Court's ruling on reapportionment in 1964 whereby State legislative houses must be apportioned on a population basis—the one-man, one-vote rule—will assure greater equity in the allocation of these funds within the States. This will mean greater suburban representation, and hence, a more sympathetic response by State legislatures to urban requirements. Available statistics reveal that the State governments are already giving extensive assistance to the political units within their boundaries. During fiscal year 1965, $14.2 billion, or 35 percent of total State general expenditures of $40 billion, represented payments to local governments. Similarly, these payments constituted 29 percent of total general revenues of local governing bodies.

It has been argued that State and local governments, in the expectation of further Federal assistance, may reduce their own taxes and curtail vital programs of expenditure. However, as Dr. Heller suggests, any tax-sharing plan adopted might be so designed as to take into account the tax effort made by recipient governments, and if they do lower their fiscal effort, action could be taken reducing the amounts which might be allocated to these political units.

To the argument raised that State and local units will not use their allotments in the wisest way, it may be demonstrated from statistical data available, that a large proportion of total State and local outlays over the past years has been for educational, health, and welfare purposes—an indication that they are cognizant of the growing needs of their people in these areas and are attempting to meet them.

Grants with little or no Federal strings attached would be a boon to low-income cities and States. Stringent matching requirements currently imposed by the Federal Government on many of its grant-in-aid programs make it difficult for some of these governing bodies to take advantage of such aid, and if they do, frequently it must be at the expense of other vital services. If the funds are allocated on the basis of population and per capita income, needy areas would stand to benefit more than the richer districts. Thus, it would bring about a more equitable distribution of revenues among the States and localities.

Enactment of Federal tax-sharing legislation will, it is claimed, mark a step toward achieving a "Creative Federalism" whereby a real

working partnership between our National, State and local governments will be realized.

Finally, since the State and local governments may well spend these shared revenues for education purposes, it can be argued that this would relieve the Federal Government from making a decision on the controversial question of granting Federal aid to religious institutions.

B. ARGUMENTS AGAINST FEDERAL TAX SHARING

With Federal costs soaring as a result of the war in Vietnam, the Government can ill afford to add several billions of dollars more to its outlays, bringing further dislocations in the Federal budgetary situation and adding to the burden of our huge national debt.

When the idea of Federal tax sharing began to receive public attention in 1964, it was believed that it could be financed out of budgetary surpluses produced by a booming economy. Now, however, with acceleration of the war in Southeast Asia, there is little hope of achieving a balanced budget with any excess in revenues in the foreseeable future. During the past 30 years, budgetary surpluses have been the exception rather than the general rule. In only 6 years out of the period from fiscal year 1937 through 1966 was a surplus realized. As the Treasury closed its books on June 30, 1966, another deficit of $2.3 billion was incurred. And the President in his 1967 state of the Union message predicted even higher deficits in the years ahead. For the current fiscal year, 1967, he estimates a deficit of $9.7 billion. Beyond that, even assuming that his latest tax recommendations are enacted, another $8.1 billion deficit is anticipated for the fiscal year 1968. Latest statistics on the gross public debt outstanding report that as of January 17, 1967, it had reached $329.7 billion—the highest level in U.S. history and very close to the public debt ceiling of $330 billion. Granted that State and local governments can use this assistance, first things must come first, and the war in Vietnam has first priority on the public purse. Until this conflict is resolved, any tax-sharing program must necessarily be deferred.

Based upon a recent study published by the Tax Foundation, some assert that State and local governments are not in as difficult financial straits as is generally believed, but have adequate resources to finance their expenditure programs.

Contrary to most of the literature currently available on State-local finances, this report, *Fiscal Outlook for State and Local Government to 1975*, paints a more optimistic picture of the fiscal outlook of these governing bodies in the years ahead.

This organization concludes: "Under the conditions assumed, aggregate general revenues will grow somewhat more rapidly than spending in the decade ahead, without an increase in overall tax rates."[14] It estimates that general expenditures of State and local units of government will rise from $75 billion in 1965 to $142.1 billion in 1975. This represents an increase of 89 percent as contrasted with the 123 percent rise in the decade ending in 1965. It further estimates that general revenues of these governments will rise more rapidly than general

[14] *Fiscal Outlook for State and Local Government to 1975*. Government Finance Brief No. 7. New York. Tax Foundation, Inc., 1966. p. 1

spending. General revenues from all sources are estimated at $146.9 billion in 1975—an increase of 98 percent from the $74.3 billion reported for fiscal year 1965. Thus, it concludes that general revenues will exceed general expenditures by about $5 billion in 1975.

Others feel that a new program of no-strings grants is an inferior approach to attacking the financial problems of State and local governments. Several Cabinet officials, in particular, believe that a better alternative lies in strengthening and improving existing categorical grant-in-aid programs: urban mass transportation, the various programs attacking poverty in the United States, low-rent housing, and educational and other welfare-related Great Society programs established during the past 2 years. There is also strong sentiment that should any surplus funds become available in the future, they might better be utilized in reducing our huge public debt.

Still others believe that a better alternative method of assisting State and local governments would be the enactment of legislation which would permit individuals to credit against their Federal income tax liability a certain percentage of income taxes paid to State governments. The Advisory Commission on Intergovernmental Relations has been one of the leading proponents of such a proposal. It has recommended that a tax credit of between 25 and 50 percent (probably 40 percent) be allowed for such State income tax payments.[15] In this way the States which have generally been reluctant to rely to any great extent on income taxes as a source of revenue would be encouraged to increase existing rates or to levy such taxes where they are not imposed. During fiscal year 1965, receipts from individual income taxes constituted only 14.2 percent of all State tax revenues ($3.7 billion out of $26.1 billion). Another argument advanced in favor of the tax credit is that it would encourage a shift away from more regressive forms of taxation, such as sales taxes, to a more widespread use of the income tax which is more progressively based upon ability to pay.

Some believe that without strict Federal supervision and control, State and local units will not use the funds in a desirable way. Knowing that additional funds are forthcoming from the Federal Government, they may be tempted to reduce their own taxes and curtail essential programs. There is apprehension that rural-dominated State legislatures will make allocations of the funds which will not be in the best interest of the majority of citizens—that the money may never trickle down below the State level to local governments where it is urgently needed to help finance the mounting requirements of highly industrialized metropolitan areas. Failure of the Federal Government to control the actual distribution of funds below the State level will undoubtedly cause bitter controversy among State, county, and city leaders as to just how these funds are to be allocated. Some are of the opinion that State and local governments must first be modernized and revitalized—that unconditional block grants would only serve to perpetuate weak and ineffective State and local units.

It is further argued that tax sharing will not contribute toward decentralization of the Federal Government, but will only cause State

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[15] See *Federal-State Coordination of Personal Income Taxes*. Advisory Commission on Intergovernmental Relations, Washington, D.C., October 1965, pp. 15–19.

and local governments to become more and more dependent upon our National Government. Thus, it is feared that such a proposal will actually serve to enlarge rather than diminish Federal power. Despite the fact that many of these proposals would grant the funds with few conditions to be met to qualify for them, some fear that Federal officials would always be able to control their distribution in such a way as to penalize those States which do not conform to their specifications.

Conclusion

Undoubtedly, Federal tax sharing promises to be one of the major issues considered by the 90th Congress. Leaders of the Republican Party, in particular, have indicated that they intend to make it one of their primary legislative objectives.

Before, however, any Federal tax-sharing legislation can be adopted, some of the basic differences in the various proposals advocated must first be resolved. Should taxable income or actual taxes collected be the basis for determining the amount available for distribution to State and local governments? Should the money be set aside in a trust fund or be subject to annual congressional review via the appropriation process? What formula shall govern the distribution of the funds among the individual States? Shall they be allocated on the basis of population or on the basis of returning Federal revenues to the States from which derived? How much of an equalization factor is desirable? What weight shall be given to State-local tax effort? What provision shall be made for allocation of the funds below the State level? What incentives should be included for the reform of State and local governments? The dominant question and controversy, however, will probably revolve around just how much Federal control and supervision shall be exercised over the disbursement of these Federal revenues to the State and local governments.

APPENDIX

Federal Tax-Sharing Proposals Introduced During the 89th Congress [1]

I. BILLS PROVIDING FOR FEDERAL TAX SHARING ON THE BASIS OF AGGREGATE TAXABLE INCOME

S. 2619. Messrs. Javits, Hartke, Scott, and Mundt; October 11, 1965 (Finance).
H.R. 11535. Mr. Reid of New York; October 12, 1965 (Ways and Means).
H.R. 11553. Mr. Lindsay; October 12, 1965 (Ways and Means).
H.R. 11586. Mr. Halpern; October 13, 1965 (Ways and Means).
H.R. 11600. Mr. Ellsworth; October 14, 1965 (Ways and Means).
H.R. 11603. Mr. Morse; October 14, 1965 (Ways and Means).
H.R. 11633. Mr. Todd; October 18, 1965 (Ways and Means).
H.R. 11690. Mr. McDade; October 20, 1965 (Ways and Means).
H.R. 11735. Mrs. Dwyer; October 21, 1965 (Ways and Means).
H.R. 11770. Mr. Donohue; October 22, 1965 (Ways and Means).

Federal Tax-Sharing Act.—Establishes a tax-sharing fund and and appropriates for fiscal year 1968 and each year thereafter an amount equal to 1 percent of the aggregate taxable income reported on individual income tax returns during the preceding taxable year.

Sets forth the formula for apportioning such funds to the States, 80 percent based on population and the revenue effort ratio (revenue of the State divided by the income of individuals) and 20 percent on the basis of the 13 States with the lowest per capita income.

Sets forth certain requirements for the use of such funds and provides for annual congressional studies of the operation of the fund and the services provided.

H.R. 12730. Mr. Gurney; February 9, 1966 (Ways and Means).

Law Enforcement Tax-Sharing Act.—Provides a system for the return of Federal income tax revenues to the States to be used exclusively for law enforcement purposes.

Provides for the appropriation to the law enforcement assistance account an amount which bears the same proportion to $700 million as aggregate individual taxable income for such year bears to aggregate individual taxable income for the fiscal year ending June 30, 1966.

Payments shall be made each year to States which have approved plans for expenditure and allocation shall be based on State effort and concentration of population.

[1] Summary of these bills was derived from individual bills and the *Digest of Public General Bills and Selected Resolutions* published periodically by the Legislative Reference Service, Library of Congress. No action was taken on any of these bills by the 89th Congress.

II. BILLS PROVIDING FOR SHARING OF A CERTAIN PERCENTAGE OF FEDERAL TAX COLLECTIONS WITH THE STATES FROM WHICH DERIVED

A. On the basis of total Federal tax collections

S. 3405. Messrs. Miller, Allott, Fannin, and Scott; May 25, 1966 (Finance).

Federal Tax-Sharing Education Act.—Established a tax-sharing fund in the U.S. Treasury into which shall be paid an amount equal to 2 percent of the total Federal tax collected during the preceding fiscal year and from which moneys shall be distributed to the States for education purposes.

B. On the basis of income, estate and gift tax collections and customs duties

H.R. 10696. Mr. Brock; August 26, 1965 (Ways and Means).
H.R. 10717. Mr. Talcott; August 26, 1965 (Ways and Means).
H.R. 11435. Mr. Wydler; October 5, 1965 (Ways and Means).
H.R. 11441. Mr. Erlenborn; October 5, 1965 (Ways and Means).
H.R. 12259. Mr. Hall; January 24, 1966 (Ways and Means).
H.R. 12323. Mr. Edwards of Alabama; January 26, 1966 (Ways and Means).
H.R. 13066. Mr. Gurney; February 24, 1966 (Ways and Means).
H.R. 13212. Mr. Pelly; March 2, 1966 (Ways and Means).
H.R. 14926. Mr. Buchanan; May 9, 1966 (Ways and Means).
H.R. 17913. Mr. Cramer; September 22, 1966 (Ways and Means).

Tax Sharing for Education Act.—Declares it to be the purpose of Congress to return to the States certain portions of Federal tax revenues, which shall be used for educational purposes.

Creates an educational assistance trust fund and annually appropriates amounts equal to specified percentages of taxes paid on incomes, estates and gifts and customs duties collected. Provides that for fiscal year 1966, 1 percent of all such taxes paid and customs duties collected shall be appropriated to the fund, and that the annual percentage appropriation shall increase until it reaches 5 percent for the fiscal year 1970. Sets forth a formula for payments to the States, based on the number of pupils enrolled in public schools, the gross personal incomes of the residents of the State, and the average amount expended for education in the State during the preceding fiscal year. Requires each State to submit a State plan to the Comptroller General, giving in detail proposed expenditures for education. Gives the Comptroller General power to disapprove any State plan and declare such State ineligible for assistance. Provides judicial review for any State which is dissatisfied with the Comptroller Generals final action.

H.R. 15557. Mr. Andrews of North Dakota; June 8, 1966 (Ways and Means).

Tax Sharing for Education Act.—Declares it to be the purpose of Congress to return to the States certain portions of Federal tax revenues which shall be used for educational purposes.

Creates an educational assistance trust fund and appropriates funds to it from annual amounts paid in income taxes, estate and gift taxes, and customs duty collections. Provides that for fiscal year 1967, 1 percent of all such taxes paid shall be appropriated to the fund and that the annual percentage appropriation shall increase until it reaches 5 percent for fiscal year 1971. Sets forth a formula for payments to the States, based on the number of pupils enrolled in public schools, the gross personal income of the residents of the State, and the average amount expended for education in the State during the 3 preceding fiscal years. Requires each State to submit a State plan to the Comptroller General, giving in detail proposed expenditures for education. Gives the Comptroller General power to disapprove any State plan and declare such State ineligible for assistance.

C. On the basis of Federal income taxes

H.R. 10828. Mr. Multer; September 1, 1965 (Interior and Insular Affairs).

Payments to Local Governments Act.—Sets forth the purpose to provide for the comprehensive study to ascertain (1) the nature and extent of the need for Federal contributions to State governments to relieve hardship due to failure to raise sufficient revenue by local taxation, and (2) ways whereby such hardship may be alleviated effectively and economically. Establishes a Federal Board for Payments to Local Governments to conduct such study. Authorizes a rebate of one-fourth of 1 percent of the gross amount of income taxes collected from within territories of local governments at the close of each fiscal year and sets forth application procedures.

H.R. 1078. Mr. Matthews; January 4, 1965 (Ways and Means).

Considers one percent of Federal income taxes collected on individual incomes as State revenue to be refunded to the State for educational purposes.

H.R. 1187. Mr. Teague of Texas; January 4, 1965 (Education and Labor).

Provides for the transfer of 1 percent of the income taxes collected in a State to such State to be used for educational purposes.

House Joint Resolution 83. Mr. Poff; January 4, 1965 (Ways and Means).
H.R. 1182. Mr. Teague of Texas; January 4, 1965 (Ways and Means).
H.R. 1653. Mr. Bow; January 6, 1965 (Ways and Means).
H.R. 6651. Mr. Berry; March 23, 1965 (Ways and Means).

Provides that one percent of all income taxes collected on individual and corporate incomes under Federal statutes shall be deemed to be revenue for the State or territory within which all of it is collected, for use, for educational purposes only, without any Federal direction, control, or interference.

H.R. 5567. Mr. Derwinski; March 1, 1965 (Ways and Means).

Provides for the transfer of 1 percent of all Federal income taxes derived from each State to that State. Requires 50 percent of such transferred funds to be used for educational purposes and the remain-

der to be used for general State purposes without Federal direction, control, or interference.

S. 1011. Mr. Cotton; February 8, 1965 (Labor and Public Welfare).
H.R. 6333. Mr. Pirnie; March 16, 1965 (Education and Labor).

Federal Aid to Education Act.—Gives financial assistance to the States for educational purposes by authorizing annual appropriations to each State equal to 1 percent of the Federal individual income taxes collected therein.

H.R. 10932. Mr. Matthews; September 9, 1965 (Ways and Means).

Returns to each State 1 percent of Federal income tax collected therein for use for the purpose of paying teachers' salaries.

H.R. 3914. Mr. Ashbrook; February 1, 1965 (Ways and Means).

Provides that 2 percent of all Federal individual income taxes derived from each State shall be given to that State for educational purposes free from Federal control.

H.R. 12083. Mr. Conable; January 17, 1966 (Ways and Means).
H.R. 15592. Mr. Derwinski; June 9, 1966 (Ways and Means).
H.R. 16205. Mr. Robison; July 13, 1966 (Ways and Means).

Tax Sharing for Education Act.—Appropriates 2 percent of the Federal income taxes collected to pay to the States for use for educational purposes; sets forth a formula for the allocation of such funds to the States based on population and income per person (2 percent allotted to Puerto Rico, Guam, American Samoa, and the Virgin Islands).

Sets forth fiscal requirements and procedures, including judicial review, enforcement.

H.R. 14299. Mr. Bates; April 5, 1966 (Appropriations).

Tax Sharing for Education Act.—Provides for the return of Federal income tax revenues amounting to 2 percent of the sum of the individual income taxes collected in a State to such State to be used exclusively for educational purposes.

H.R. 6181. Mr. Skubitz; March 11, 1965 (Ways and Means).

Authorizes 3 percent of the individual income taxes collected within a State or territory to be transferred to such State or territory to provide direct aid for educational purposes.

H.R. 16903. Mr. Berry; August 8, 1966 (Ways and Means).

Directs District directors of internal revenue to transfer to each State 4 percent of the Federal income taxes collected within each State.

H.R. 2192. Mr. Dorn; January 11, 1965 (Ways and Means).
H.R. 2859. Mr. Whitten; January 14, 1965 (Ways and Means).

Provides for the transfer of 5 percent of all Federal income tax collections to the State from which derived. Requires such funds to be used for educational purposes only.

H.R. 1562. Mr. Laird; January 5, 1965 (Ways and Means).
H.R. 16947. Mr. Battin; August 10, 1966 (Ways and Means).
H.R. 18052. Mr. Wyatt; September 28, 1966 (Ways and Means).
H.R. 18252. Mr. Gubser; October 7, 1966 (Ways and Means).

State-Local Financial Assistance Act.—Provides for the payment to each State of an amount equal to 5 percent of the Federal income taxes collected in such States during the preceding fiscal year. Declares it to be the purpose of the Congress that no vestige of Federal control shall attach to such funds.

H.R. 16784. Mr. Shriver; August 2, 1966 (Ways and Means)

Federal Tax-Sharing Act.—Provides for the sharing of Federal taxes with the States by establishing a tax-sharing fund in the Treasury and appropriating thereto percentages of Federal incomes taxes paid (not including tax on self-employment income) ranging from 2 percent for fiscal 1967 to 10 percent for fiscal 1975 and each fiscal year thereafter. The Secretary of the Treasury must transfer to this fund, at least quarterly, the appropriated sums. Ninety percent of the funds appropriated for each fiscal year must be paid out to the States at least quarterly according to a fixed formula, and 10 percent shall be paid to the 15 States having the lowest per capita income according to an allotment ratio. Tax funds so shared may not be used by a State to pay its debt-service, payments in lieu of property taxes, and to provide matching in connection with any Federal grant program. Provides for equitable distribution of tax reimbursements to local governments of each State. Improper use of shared taxes by a State will result in a reduction in its future allotments. Requires each State to assure the Secretary of the Treasury it will use its funds properly and to make reports to the Secretary, Congress, and the Comptroller General how the funds were used. Requires the Treasury Secretary to report annually to Congress each year of the operation of the tax-sharing fund.

D. On the basis of cigarette tax collections

H.R. 1527. Mr. Bray; January 5, 1965 (Education and Labor)

There is authorized to be appropriated for the fiscal year 1966 and for each fiscal year thereafter an amount equal to the Federal tax collected on cigarettes sold within the States during the preceding fiscal year. Such funds shall be used by the States for educational purposes only.

H.R. 1651. Mr. Bow; January 6, 1965 (Education and Labor).

There is authorized to be appropriated for the fiscal year 1966 and for each fiscal year thereafter an amount equal to 25 percent of the Federal tax collected on cigarettes sold within the States during the preceding fiscal year. Such funds shall be used by the States for educational purposes only.

III. BILLS PROVIDING FOR TAX SHARING ON THE BASIS OF INCOME TAX LIABILITY

H.R. 6470. Mr. Dowdy; March 18, 1965 (Ways and Means).

Provides for retention by District Directors of Internal Revenue in a State an amount equal to 2 percent of aggregate income tax liability less credits allowable. Sums retained shall be transferred to State treasurers and shall be used for public education purposes only.

IV. OTHER BILLS PROVIDING ALTERNATIVE MEANS OF ASSISTING STATE AND LOCAL GOVERNMENTS

H.R. 16269. Mr. Culver; July 14, 1966 (Appropriations).

State and Local Assistance Act of 1966.—Provides Federal financial assistance to State and local governments in an annual amount equal to a specified percentage ranging from one-half of 1 percent to 2 percent of the gross national product.

H.R. 17998. Mr. Fraser; September 27, 1966 (Ways and Means).

Revenue Sharing Act of 1966.—Provides financial assistance to State and local governments by establishing in the U.S. Treasury a State and local assistance fund and appropriating thereto an amount equal to a specified percentage of State and local tax revenues, ranging from 6 percent for the fiscal year 1968 and increasing to 25 percent for the fiscal year 1978 and each fiscal year thereafter. Payments are authorized to be made (on the basis of population) to those States which have had a plan approved for distribution of their share among taxing jurisdictions within their boundaries.

STRENGTHENING THE FISCAL BASE OF OUR FEDERALISM*

BY WALTER HELLER

Just as Federal economic policy making and policy itself have taken on new dimensions, the fiscal problems of federalism are entering a new stage. After years of wandering in the wilderness of "political problems which are insoluble and economic problems which are incomprehensible"—to adapt a favorite phrase of Sir Alec Douglas-Home—Federal-State-local fiscal relations are at last on the threshold of a promised land created by vigorous economic growth and balanced political reapportionment. Growth is generating a flow of Federal revenues which will permit the study of major new fiscal coordination devices to move from the barren ground of hypothetical discussion—where it has languished for 30 or 40 years—to the fertile ground of practical, fundable proposals. And reapportionment will strengthen the legislative base for new initiatives to revitalize the States.

In looking anew at methods to strengthen the fiscal base of our federalism, we are dealing with a combination of economic and political forces which provides ideal grist for the mill of applied political economy. So the scholar who is happiest in the austere Never-Never-Land of logical positivism will find cold comfort in this chapter. But the man of affairs who yearns for the value-laden Ever-Ever-Land of normative choices will find himself very much at home.

The great prosperity that opens these new fiscal vistas presents the two faces of Janus to different levels of government. At the Federal level, economic growth and a powerful tax system, interacting under modern fiscal management, generate new revenues faster than they generate new demands on the Federal purse. But at the State-local level, the situation is reversed. Under the whiplash of prosperity, responsibilities are outstripping revenues. As Galbraith has suggested, prosperity gives the Federal Government the revenues, and the State and local governments the problems. Or as L. L. Ecker-Racz has said: "There is no escaping the conflict because . . . national progress bestows both bounties and burdens: the bounties tend to be national, the burdens State and local." Nevertheless, the dominant note, and the hopeful one, is that the Federal revenue flow is now large enough to redress the fiscal balance under peacetime conditions.

Side by side with this new economic-fiscal dimension is the new political-constitutional dimension of the Supreme Court's reapportionment decisions. It is redressing the political balance in State legislatures away from rotten boroughs and lopsided rural representation toward the urban, and especially the suburban, constituencies. This

*Reprinted from: Heller, Walter, *New Dimensions of Political Economy*, Harvard Univ. Press, Cambridge, Mass., 1966, Chapter III.

offers us the prospect of new blood, greater responsiveness, and greater vitality in our State legislatures. This promise was painted in glowing terms by Senator Joseph D. Tydings recently when he said that "the Supreme Court's reapportionment decisions, which the self-proclaimed champions of 'States' rights' so bitterly assail, will do more to rebuild our withering Federal system than any other event in this century."

So the promise of reapportionment, the prospect of Federal fiscal dividends, and the fact of severe fiscal pressure on the States all call for a new look at the Federal-State-fiscal relationship. Success on the new frontiers of positive Federal economic policy enable us to explore some of the old frontiers of our federalism and to take positive steps to strengthen and secure those frontiers.

The way in which we resolve the problem of fiscal imbalance will have a profound effect on the future course and strength of our federalism.

It will have a major impact, first of all, on the harshness of the terms on which State and local governments reconcile their rapidly rising expenditure obligations and their limited—and often overworked—tax base. Balance their budgets, they will—indeed, under most State constitutions, they must. But the key question is—on what terms, both as to the level of public services and as to the regressiveness of their tax structures, will they strike this balance?

Second, the size and form of Federal fiscal support to State-local government will be a major factor in shaping our national fiscal system in the longer run. It will strongly influence both the over-all distribution, by income groups, of our Federal-State-local fiscal burdens and the pattern and extent of geographical inequalities in tax burdens and service levels.

And, third, the way we resolve this question will affect the relative strength of Federal and State-local governments. Or, to put it differently, it will affect the basic role and vitality of the States.

Vietnam, of course, has postponed the happy day when the hopes of the States for some new and generous form of Federal financial support can be realized. First, the requirements of Vietnam itself must be met. Second, putting the Great Society programs back on schedule will demand large sums. Third, occasional talk of a $20 billion antimissile defense system has a chilling contingent impact on State hopes.

But the power of the Federal revenue system is so great, and the pressure of State-local needs so unrelenting, that the basic issue will be ever with us. Given the fiscal, political, and philosophical swamps and thickets through which we have to thread our way en route to a resolution of this financial dilemma, we have no time to lose in putting our minds to it.

The Role of the States

A determination to strengthen the weak State-local link in our fiscal federalism must be anchored in the conviction that the States are here to stay, that they do play an indispensable role in our federal system of government.

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We need to be sure, in other words, that we still believe in a federalism rather than a unitary government—that we would not accept the view of my Parisian friend, a scientist, who wrote recently to applaud what he calls the "phagocytosis" of the States by the Federal initiative, their transformation into "sectors or departments." He said, admiringly, that "from a federation the United States are at last becoming a nation." And I thought, "How French!" Yet it was his countryman, Alexis de Tocqueville, who pointed out, well over a century ago, that although a continental country can be successfully governed centrally, it cannot be successfully administered centrally. Richard Goodwin adds that with regard to the Nation's problems today, "We are not wise enough to solve them from the top, nor are there resources enough to solve them from the bottom."

But, more specifically, is there a truly persuasive case—one that we will accept as a cause for action—for revitalizing and strengthening the States as units in our Federal structure? I believe there is.

One can put it in terms of the negative imperative of de Tocqueville and Goodwin that there is neither the administrative capacity nor the problem-solving wisdom at the top. Or, to put it more bluntly, the Federal Government simply cannot carry out large segments of its responsibilities at all—or at all efficiently—without strengthening the States and localities. A very large part of what we do through government is done through State and local units. They are the ones to whom we usually turn as we seek to maintain and upgrade our educational efforts, improve our physical and mental health, redevelop decaying urban areas, build safer and better highways, overcome air and water pollution, and equip our suburbs with water systems, sewers, roads, parks, schools, and the like. This list is striking partly because each item on it represents either an essential function or a reasonable aspiration of a great and growing society; partly because each item falls squarely within the traditional sphere of State-local operations; and partly because so many items on the list are suffused with a national interest that transcends State and local lines and demands Federal action and support.

Education is a case in point. State and local governments raise about 90 percent and spend 100 percent of the funds we devote to public schooling. Yet education is an essential instrument for carrying out functions that are a direct Federal responsibility. Education is an investment in human brainpower from which we reap positive gains in the form of higher productivity, more rapidly advancing technology, a better informed foreign policy, and a stronger national defense. In this light, one might add, Federal support of locally operated and locally controlled public education is no act of charity or largesse. It is simply creative and cooperative federalism at work, a means of discharging certain national obligations through traditionally local institutions. Local initiative and effort are already harnessed to the national interest. Federal funds simply mean that the national interest in the results will be matched by a national effort in financing them.

One may also observe that each decade, one-sixth of the U.S. population changes its residence across State lines. Our great mobility, combined with sharply unequal educational opportunities, again in-

volves the national interest. Inequality plus mobility means that no community is immune to the effects of substandard education. Only the *federation* of States—operating through its agents; namely, the President and the Congress—can surmount this problem. How? By taking over the schools? No, by providing the equalizing financial support needed to raise the national floor of education to at least an acceptable minimum.

If we want State and local governments to be efficient partners in our federalism, we have to strengthen the whole fabric of government at their levels. Great inequality in the access to knowledge, in the available skills, and in the techniques used—in a word, in the competence of government—will distort and endanger the partnership. It will create disparities in the capacity for planning, and for effective action, and thus lead to inefficiency and frustration. The potential for constructive cooperation is undermined when State-local government is so understaffed—both quantitatively and qualitatively—and so under-financed that it cannot meet the Federal bureaucracy on reasonably even terms.

Getting a bit ahead of our story, I might note that these inequalities have been recognized and dealt with on a function-by-function basis through our myriad Federal grants-in-aid. These have served to reduce disparities and increase the quality of service in many specific areas of State-local activity. But we still seek the fiscal formula that will improve the *total* capability of State-local government, and with it, of government as a whole. States and localities—either as they now exist, or perhaps with growing emphasis on both regional and metropolitan-area groupings—will continue to be the service centers through which important national purposes are achieved. If we don't want those purposes thwarted or diluted, we had better strengthen these operating units.

But that is not the whole story. There are also more positive reasons why the States and their subdivisions should have a stronger role. Creative federalism requires diversity and dissent and innovation. Yet these cannot simply come down from on high. They have to well up from below. The danger if they do not is that the Central Government will grow stronger in authority and weaker in ideas. Clearly, under President Johnson's concept of creative federalism, State and local governments are not the only sources of creative ground swell. The creative process can also center in the universities, in nonprofit foundations, in poverty-program councils, in hospitals, and so on. But the States and localities are still the most essential part of a mechanism for feeding ideas up the line and having them come back down with money attached.

We tend to think that the innovative fire in the States went out with the elder Robert La Follette. And, in truth, it is not easy to visualize any State of the future matching Wisconsin's path-breaking leadership in income taxes, in unemployment compensation, in public utility regulation, and in public administration—leadership fueled in substantial part by ideas flowing from the university to the State house. But neither is it hard to find contemporary evidence of innovation and pioneering in the States. To illustrate their role as "innovators of enlightened programs of government," Senator Edward M.

Kennedy cites Kentucky's highway beautification program, Virginia's department of aging, Rhode Island's medicare program, and California's measures to combat air pollution from automobles. One can add Wisconsin's outdoor recreation program, California's system of 2-year community colleges, and North Carolina's poverty program. And perhaps Nevada's open gambling laws and New Hampshire's State lottery deserve inclusion as experiments—quarantined by State boundary lines—which will prove to be fine examples of "how not to do it." Thus, Justice Brandeis' "laboratories of the federal system" have not gone out of business.

Finally, one need not dwell on the virtues of State and local governments as the chosen instruments of the political decentralization and dispersion of power essential to a democracy. Their role here is well known. But that makes it no less fundamental.

My basic premise, then, is that to the simple question, "Do you want stronger State government?" the country's answer is unequivocally, "We do." If we do not accept that basic premise, if we are unrelenting Hamiltonians—or perhaps Spencerians who yearn for that government that governs least, who stand on their States' rights so they can sit on them—then all of the succeeding syllogisms, no matter how logically unassailable, will not convince us that Federal revenues should be shared more generously with the States.

State-Local Fiscal Pressures

The next point in the fiscal syllogism is also simple: the States just cannot go it alone fiscally. To put it crudely, we have to find some sort of joint fiscal solution to their enormous and growing problems which will enable Governors to be bold and innovative and expansionary and wake up the day after election still in office. Again and again, good Governors have been defeated by the higher taxes they have had to espouse to finance their innovations and expansion. This was borne in on me most vividly in 1960 when Governor Orville Freeman of Minnesota was running for a fourth 2-year term. He made a point of forthrightly telling the voters that "there ain't no Santa Claus," that if they wanted the services, they would have to pay for them in higher taxes. And after the election, he woke up, not Governor, but Secretary of Agriculture—where, in the eyes of some critics, he *is* Santa Claus (though he may feel more like Scrooge).

Even apart from the political hazards of raising taxes, the States have to cope with serious economic and institutional handicaps.

First and foremost, interstate competition, and fears of losing industry and wealth, not only inhibit State-local taxing efforts but push them in regressive directions. In speaking of this destructive and self-defeating tax competition, Ecker-Racz notes that although "the influence of tax considerations on the location decisions of business is grossly overstated . . . its impact on State and local taxation is not." I doubt that he overstates the case when he says: "Fear of losing business to another jurisdiction haunts the mind and stills the pen of the State and local lawmaker, and special pleaders have developed the skill of exploiting this fear to a high art."

Second, limited jurisdiction and small size deny local and State tax agencies most of the economies of scale enjoyed by the Internal Reve-

nue Service, hamper their administrative and enforcement efforts, and bias State-local taxing systems toward the property and consumption taxes.

The third handicap arises largely out of the first two. In contrast to Federal reliance on growth-responsive taxes—taxes whose revenue rises proportionately faster than the gross national product—States and localities depend largely on taxes that respond sluggishly. They draw nearly four-fifths of their total tax revenues from sources—property taxes (45 percent) and sales and gross-receipts taxes (33 percent)—whose yields, at stable tax rates, barely keep pace with the growth of the economy, rising a trifle less than 10 percent for every 10-percent rise in GNP. They draw only 8 percent from the highly responsive State personal income tax, whose revenues grow 16 to 18 percent for every 10-percent rise in GNP.

Limited State reliance on income taxes reminds us of a fourth barrier; namely, heavy Federal reliance on selected tax sources. References to the Federal preemption of the income tax are not uncommon. Since the Federal Government allows the deduction of State income taxes in arriving at taxable income—thus shielding taxpayers, especially those in the higher income groups, from the full impact of duplication—and since the States that are the heaviest users of the personal income tax have effective rates (as a percent of Federal adjusted gross income) eight times as high as those that make lightest use of the tax, one has difficulty distinguishing between reason and excuse. Nonetheless, it seems clear that the high Federal income tax does inhibit the States and localities in the use of this progressive tax source, for how else would one explain the virtual halt in State income tax enactments in the 1940's and 1950's.

Beleaguered State-local officials see Federal-State fiscal disparities in even bolder relief when they turn their attention from their viscous tax sources to the free-flowing budgetary uses of their revenues. From 1955 to 1965, State-local expenditures rose by 125 percent, nearly twice the Federal increase of 65 percent. Federal spending thus lagged behind the 70 percent growth in GNP during the same period. But State-local spending grew 80 percent faster than GNP. At the end of the period the State-local share in total civilian government spending was 77 percent, the Federal share only 23 percent. Even if we shift Federal grants-in-aid into the Federal expenditure column, the ratio is still two thirds to one third.

What these figures reflect is not a conscious assertion of States' rights and responsibilities, a renewed and conscious pursuit of the virtues of local self-government, but a response to the irresistible pressures of population, prosperity, and price trends.

Population burdens State-local budgets, not just by its 17-percent overall growth from 1955 to 1965, but by its composition—by the 37-percent rise in the school-age population and the 25-percent rise in the over-65 group. And population is not only growing fast but moving fast, particularly into urban areas. From 1950 and 1960 the population in metropolitan areas increased from 56 to 63 percent of the U.S. population, and by 2000 the figure will be 75 percent. Per capita government expenditures and revenues average some 30 percent higher in metropolitan areas than elsewhere. Mobility and urbanization—

and particularly the flight to the suburbs—call for ever *more* schools, roads, parks, sewers, for more and costlier services.

Meanwhile, *prosperity* generates demands for *better* schools, roads, and parks, for new and better services. And it generates them faster than it produces added State-local revenues. Further, the growth that confers such a bountiful harvest of revenues on the Federal government leaves the States and their subdivisions a bitter harvest of air and water pollution, disappearing green space, and urban rot. Truly, prosperity gives the National Government the affluence and the local governments the effluents.

Price trends, too, work against State-local budgets. From 1960 to 1965 the increase in the State-local price deflator—a measure of the price increases of goods and services bought by State and local governments—averaged 3 percent a year. This was a bit more than double the increase in the overall GNP deflator. Going back another 5 years does not change the picture: from 1955 to 1965 prices paid by State-local governments rose 40 percent—including a 60-percent rise in teachers' salaries—while the GNP price deflator rose roughly 20 percent. Given the present $70 billion a year of State-local purchases, one has to add $2 billion a year simply to take care of price increases.

One can go on in the words of Orville Freeman: "And consider this irony of the inflation situation. If price levels continue to rise, the figures just quoted indicate that our State budgets will suffer proportionately more than family budgets, business budgets, and Federal budgets. At the same time, if the Federal Reserve System puts on the tight money screws in its efforts to stop inflation . . . the interest rates in our tremendous borrowing program rise sharply. What happens? We are caught either way, or perhaps I should say, both ways." His words were written in the summer of 1959.

State-Local Fiscal Efforts

In meeting these unrelenting pressures, State and local bodies should, can, and will do more to tax themselves. That they have not been standing idly by is amply demonstrated by the recent fiscal record. While an average cut of 15 percent in Federal tax rates since 1961 was bringing the ratio of Federal tax collections to the GNP down to its lowest point since the war—14.4 percent in 1964—State tax rates were rising sharply, continuing the trend that has increased the share of State-local taxes in the GNP from 5.4 percent in 1946 to 8.0 percent in 1964.

In the 1955–65 decade States and localities increased revenues from their own sources from $28 to $63 billion, or by an average of 8.6 percent a year. Meanwhile, Federal grants-in-aid grew from $3 billion to $11 billion. In other words, the States financed from their own sources about 85 cents out of each dollar of new spending. And hard as they have worked their reluctant tax sources since the war, raising their yields more than fivefold, they have raised their net debt even faster—from less than $14 billion in 1946 to roughly $95 billion 20 years later, a sevenfold increase.

The remarkable fiscal efforts made by State-local government are also reflected in the brisk business in new and used taxes that was done

by the State legislatures from January 1965 through June 1966. Five States enacted new sales taxes (Idaho, Massachusetts, New Jersey, New York, and Virginia), while eight others increased their rates. A new personal income tax was enacted in Nebraska, and eight other States increased rates. Eight increased their corporate income tax rates. Oregon, long a holdout, adopted a cigarette tax, while 15 others increased rates. Finally, seven States increased liquor tax rates and 10, gasoline tax rates. This list translates the growing pressures on the States into vivid and painful specifics.

The spate of tax increases attests not only to the great fiscal pressure on State governments but to their fiscal courage, their fiscal effort, and, one might add, their fiscal ingenuity. Starting with Indiana in 1963—and Colorado, Hawaii, and Massachusetts have followed suit since then—income tax credits are being used to take the regressive curse off sales taxes. In effect, these States build a personal exemption into the sales tax by granting a per captia credit (Indiana's $6 credit amounts to a $300 per capita exemption under its 2-percent sales tax) which can either be deducted from State income tax liabilities, or if none exists, claimed as a cash refund. Massachusetts limits its credit to those whose taxable income does not exceed $5,000. Hawaii has put its credit on a gradually diminishing basis as income increases. These refinements are aimed at converting the sales tax into a progressive tax. Through this interlocking of sales and income taxes, we may yet make a silk purse out of a sow's ear.

Giving States and localities an A-plus for their tax efforts is not, of course, to say that they have done all they should. Until local government structure is reformed, until State-local tax administration is strengthened, until the laggard States and localities raise their tax efforts to the levels of the leaders one's praise must be qualified. But to infer that the Federal Government should not enlarge its fiscal support of the States until they have taken these steps, as some critics do, not only ignores the herculean efforts that have been made, but fail to see that greater Federal support and growing State-local reform can go hand in hand, indeed, that such support can facilitate or even stimulate reform.

The Commanding Case for Federal Support

Twenty years of spectacular growth in State-local taxes and Federal grants-in-aid have brought no letup in the fiscal pressure. Is any respite in sight? Rough projections from past experience, not surprisingly, do not suggest any. Even assuming a slowdown in the growth rate of State-local spending to 7 percent a year (from its 8½ percent pace of the past decade), Joseph Pechman projected State-local general expenditures at $103 billion in 1970. Keeping pace with an assumed GNP growth of 5 percent annually. State-local receipts (including Federal grants) would reach only $88 billion, leaving a $15 billion gap.

A more detailed estimate by Dick Netzer puts general expenditures at $104.5 billion in 1970, 40 percent above the 1964 level. He puts total revenue needs at $121 billion and available receipts at $111 billion. To close this $10 billion gap by added State-local tax callections would require an 18-percent increase in State-local tax rates. Selma Mushkin

and Gabrielle Lupo, in their Project '70 study, see much the same total revenue needs ($122 billion), but see no gap under their "high revenue" assumption (which includes $86 billion of general revenues, $22 billion of Federal aid, and $15 billion of gross borrowing), and only a small gap under their "low revenue assumption."

Each of these projections is reasonable, given its assumptions. And the broad assumptions of each are also within reason. Two show sizable gaps to be closed by State-local taxes or other measures, while the third draws on an assumed doubling of Federal grants in 5 years, together with a rise in gross borrowing, to cover revenue requirements in 1970.

Since the third—the Mushkin-Lupo projection—is the most recent and exhaustive, it will probably lead some observers to conclude that State and local governments can meet future revenue need without undue strain. But before anyone reaches this complacent conclusion, let him knock on any fiscal door or scratch any fiscal surface at the State or local level—let him probe the reality that lies behind and beneath the statistics he uses as his point of departure. Let him find a single major city or State that is not under fiscal duress, that can meet its pressing needs and aspirations without fiscal heroics.

Let him look in his own suburb and see the unmet needs for school facilities, sewers, sidewalks, street lights, green space, more frequent garbage and trash collection. Or in his central city, let him observe the rutted streets and crumbling curbs, the deteriorating parks and the miserable housing in the urban ghettos, the masive fight still ahead of us against poverty, delinquency, and crime. Or in his State, let him not be misled by the temporary fiscal frosting of surpluses from the unexpected surge in revenues growing out of the Vietnam-charged boom. There's hardtack, not cake, just underneath: the near-doubling of higher education expenditures in the next 5 years; the fight against air and water pollution which has only just begun; the crying needs for better prisons and mental hospitals.

Nor should he forget that thousands of school districts in our rural and urban slums need to raise their teachers' salaries to (or, in logic, beyond) the national average of $6,800, and that the average districts aspire to the $10,000 salaries and the kindergarten and preschool programs of the leading districts. Let him contemplate the fiscal plight of New York City or the curious sight of California, one of our richest States, breathlessly trying to catch up with its galloping governmental needs. And let him count the cost of keeping up with pioneering States which, like the Joneses, "keep on doing things we can't afford"; for example, New York's billion-dollar program to purify its waters; or its Medicaid program with its startling costs; or Wisconsin's outdoor recreation program; or California's community colleges.

And lest the man of means thinks he can insulate himself from these problems and poisons, let him fly into Los Angeles on a smoggy day, or sail on a polluted river or bay, or hire the products of substandard schooling, or assure his family and business of adequate supplies of pure water. Even with large private means, he cannot "buy free" of all the problems created by the neglect of State-local fiscal health.

Statistical projections, then, are essential for planning, for defining our problems. But projections are not forecasts, and forecasts are not goals. Our fiscal planning for federalism has to prepare for the worst—

for the minimum demanded by quantitative projections—while it plans for the best—for the maximum demanded by our qualitative goals and aspirations in a framework of abundance.

But statistical projections alone tend to beg the question. That question, as noted early in our discussion, is not *whether* States and localities can make ends meet, but *on what terms.* On terms that just cover the irresistible minimum or that meet our aspirations? On terms that force our Federal-State-local tax system into a more and more regressive mold or that protect its progressivity? On terms that perpetuate the great inequalities among the States or that steadily reduce them? On terms that will enable State and local governments to become vital and creative cogs in the machine of federalism, or just overburdened service stations? That brings us face to face with the question of what kind of fiscal federalism we want.

Out of the $28 billion increase in State and local tax revenues between 1955 and 1965, 44 percent came from increased property taxes, 34 percent from increased sales and gross receipts taxes, and only 14 percent from individual and corporate income taxes. Coupled with sharp reductions in Federal income tax rates during the same period and increases in social security payroll taxes, the increases in State-local taxes are moving us in a regressive direction. In sketching the national fiscal blueprint for the future, do we really want to design an over-all Federal-State-local tax system in which—to put it in extremes—we dismantle the progressive and comparatively equitable Federal income tax while leaning ever more heavily on the regressive and comparatively inequitable State-local property, sales, and excise taxes? Or should we seek a system in which the powerful Federal income tax is used to support expenditures which otherwise either could not be made at all, or would have to be financed from regressive tax sources? My questions readily reveal my preferences.

Next, we encounter large disparities in economic and hence taxable capacity among the States which lead to perverse ratios in both State-local service levels and tax efforts; the wealthy States enjoy higher levels with less effort than the poorer States. For example, total State-local expenditures per capita in 1964 ranged from a high of $576 in Nevada to a low of $217 in South Carolina, a ratio of more than 2½ to 1. For public education, the range was from $201 in Utah to $91 in South Carolina, a ratio of more than 2 to 1. For public welfare, the highest per capita outlay is four times the lowest; for public health, it is five times. Even when we take the average of the highest five and the lowest five States in the various expenditure categories, the disparities are large and distressing:

	General expenditures	Education	Public welfare	Health and hospital
Highest 5	$511.96	$197.03	$52.58	$38.56
Lowest 5	252.40	94.17	14.97	14.34

The perversity of these ratios grows not only out of the obvious concentration of low-income families in the low-income States, but from the higher ratio of dependent population to working-age popu-

lation in those States. In 1959–60, the 10 States with the highest ratios of dependent population ranked among the lowest in per capita income, and vice versa.

Turning to the tax side, one finds that the richest States—even though they make less 'tax effort"—raise twice as much revenue per capita from their own sources as the poorest States. In 1964, the five top States in terms of per capita revenue collections (New York, Nevada, California, Wyoming, and Washington) collected $396 per capita against $197 per capita in the five bottom States (South Carolina, Arkansas, Mississippi, Alabama, and Kentucky). Yet tax effort in the poor States is somewhat greater than in the rich: while the 10 richest States realized their revenue bounty with only a 12-percent tax burden as a percentage of personal income, the 10 poorest States drew their meager ration from a 13-percent tax burden.

The general conclusion that the poorest States are on the average making a greater effort in terms of tax-to-income ratios than the richer States—and getting a much poorer diet of governmental services for their pains—is a serious indictment of the workings of our fiscal federalism.

If the State and local governments are forced to solve their fiscal problems at the lowest common denominator arising out of interstate competition, limited jurisdiction, and inequality, their tax structures will deteriorate, and their vigor will be sapped. Without greater Federal help, they will face a disheartening battle for higher, and highly unpopular, taxes. That battle, combined with their inability to provide the services expected of enlightened governments in an affluent society, could seriously weaken their role in our federalism.

The inability of State and local governments to deal with the social and economic disaster of the 1930's was a severe blow to their prestige and influence. Since World War II, their quantitative role has been growing steadily. Indeed, they can lay claim to being the country's greatest "growth industry." Their expenditures have expanded more rapidly than those of any other major sector of the economy, public or private.

But rising responsibilities are not necessarily synonymous with rising strength. Whether greater activity leads to growing vitality depends on the flow of ideas, energy, and imagination applied in coping with these responsibilities. That, in turn, requires a sufficient flow of money to command the services of competent and imaginative people and to provide them with the funds to carry out their ideas. How far the revitalization process goes will depend on the financial and intellectual resources that State and local governments can command. Improvements are being made, and the caliber of State-local administration is rising. We need to accelerate that process.

What this calls for is not some senseless sacrifice of essential Federal authority on the altar of "States' rights," but a fiscal realinement that will simultaneously promote essential national interests and strengthen State-local capacity to serve without undermining the State-local will and capacity to govern.

In an era when painful fiscal pressures at the State-local level coexist with pleasant fiscal dividends at the Federal level, State and local

governments have a commanding case (Vietnam aside) for stronger Federal financial support—in a form that will help redress the Federal-State-local fiscal balance *and* maintain the autonomy and strength of the States.

BEYOND GRANTS-IN-AID

A consideration of ways and means of enlarging Federal support for States and their subdivisions should begin with a recognition of the powerful assist that they are already getting from Federal aid, tax cuts, and policies for sustained prosperity.

The rise in Federal aid to State and local governments (including loans and shared revenues as well as grants) has been little short of spectacular. From about $4 billion in fiscal 1957, such aids have grown to a programed $14½ billion in fiscal 1967. And they now represent one-tenth of total Federal cash payments to the public, double their proportion a decade ago.

Less direct is the State-local bounty derived from huge tax cuts in a slack economy. An estimated $3 billion extra a year is flowing into State-local coffers from the 1964 income tax cut alone, a 7-cent increase for both State and local tax revenues. Most of this comes from economic expansion generated by the tax reduction. But some comes from the direct additions to the tax base of the 19 income tax States that allow Federal income taxes as a deduction. The broad excise tax cuts of 1965 provided further stimulus and presumably opened some opportunities for States to rush in where the Federal angel no longer treads. Yet the list of attractive opportunities growing out of the excise tax reductions proved to be surprisingly short.

The ever-firmer commitment of the Federal Government to maintain a higher-employment, high-growth economy under the Employment Act of 1946 provides a firmer base for the States' and localities' own fiscal efforts. They can afford to be less fearful of repeated recessions, and they can count on higher average revenue yields at any given level of tax rates. Also both the management of Federal economic policy, which requires timely declaration of fiscal dividends, and the results of successful policy, which keep Federal coffers full, provide a favorable setting for more generous support to the States. This is reflected partly in the great growth of Federal aid, and partly in the new emphasis on "creative federalism"—for example, on the sharing of money and responsibility with community groups in the poverty program, with various State and local units in the fields of air and water purification, mass transportation, and urban development, and with municipal authorities under the proposed Demonstration Cities program.

As we parcel out future fiscal dividends, grants-in-aid will be near the head of the queue. Conditional grants for special functions play an indispensable role in our federalism. They unite Federal financing with State-local performance in a fiscal marriage of convenience, necessity, and opportunity:

- *convenience*, because they enable the Federal Government to single out and support those State and local services in which there is an identified national interest. I have in mind particularly those services, like education and health, whose benefits in a country

with a mobile people spill over into communities and states other than those in which they are performed. Functional aids enable the Federal Government to put a financial floor under the level of specific services that is consistent with our national goals and priorities.

- *necessity*, because without this financial support the States and municipalities would be unable to meet the demands on them for essential services. Failure to meet these demands would eventually mean yielding the functions to the Federal Government and thus weakening the fabric of federalism.
- *opportunity*, because putting the grants in conditional form enables the Federal Government to apply national minimum standards, insure financial participation at the State and local levels through matching requirements, and take both fiscal need and fiscal capacity into account.

But, on several counts, virtue gives some ground to vice. The aids that so admirably serve the national purpose may put State-local finance at cross purposes. In drawing on a limited supply of resources to finance and staff particular functions, the matching grant tends to siphon them away from the nonaided programs. And the poorer the State, the greater the tax effort that must be made to achieve any given amount of matching, and hence the less that is left over for the nonaided functions. To some extent, then, the State-local government trades fiscal freedom for fiscal strength.

Federal grants to serve highly specialized objectives have proliferated in recent years. And once established, they do not yield gracefully to change or abolition. Unless this trend is reversed, Federal aids may weave a web of particularism, complexity, and Federal direction which will significantly inhibit a State's freedom of movement. The picture of Gulliver and the Lilliputians comes to mind.

We must move toward broader categories that will give States and localities more freedom of choice, more scope for expressing their varying needs and preferences, within the framework of national purpose.

Perhaps we should replace our myriad categories of educational aids with broad classes such as elementary, secondary, and higher education. Or perhaps the Elementary-Secondary Education Act of 1965, which goes against the tide of particularism, points the way. Funds under this act are distributed in proportion to the number of school children in low-income families. Within the general requirement that moneys are to be applied to the needs of educationally deprived children, considerable latitude is allowed local and State boards of education to formulate specific plans.

Federal aids have risen from about 3 percent of State-local revenues in the 1920's, to 10 percent in the late 1940's, and 15 percent in 1965–66. This trend will and should continue. We have reached the point, though, where some restructuring of our system of Federal aids—some movement toward less conditional and less specific grants—is needed to maximize their contribution to the national interest not only in strong services but in a strong federalism.

But the conditional grant for specific purposes, for all its good works and even in its optimal form, falls short of the full fiscal needs of our

federalism. Part of this is simply a recognition that even the rapid expansion of aids now in prospect will not enable State and local governments to make ends meet on acceptable terms. Part of it is that they need help in financing their nonaided functions—and it is only right that the Federal Government temper the wind to the lambs it has shorn. And part of it is that the conditional grants are not well-suited to serve the intangible objectives of greater self-reliance and over-all vitality in State and local government. What we seek, then, are major new "methods of channeling Federal revenues to States and localities which will reinforce their independence while enlarging their capacity to serve their citizens."

Such new methods must run the gauntlet of the several demanding criteria that emerge from our examination of the fiscal problems of federalism. Ideally, any new plan or approach should supply Federal funds to the States in ways that will (*a*) not only relieve immediate pressures on State-local treasuries, but hitch their fiscal wagon to the star of economic growth; (*b*) improve the distribution of Federal-State-local fiscal burdens; (*c*) reduce economic inequalities and fiscal disparities among the States; (*d*) stimulate State and local tax efforts; and (*e*) build up the vitality, efficiency, and fiscal independence of State and local governments.

The device that can serve all of these ends at once is yet to be found. But I believe that per capita revenue sharing, or some allied form of unfettered general assistance, will come closer to doing so than any alternative proposed thus far. In explaining and appraising the revenue-sharing proposal, I will of course be making a case. Yet that case should be interpreted less as a defense of a particular plan than as a brief for a general approach.

Per Capita Revenue Sharing

A forerunner of this device was used in the days of Andrew Jackson. With his acquiescence, Congress declared fiscal dividends to the States in 1837 out of the embarassingly large Federal surplus produced by customs duties and proceeds of Federal sales of public lands. Funds remaining after the national debt was retired were distributed to the States in proportion to their respective numbers of congressmen and senators—a reasonable approximation of a per capita allocation. The distributions were made without restriction as to purpose but were formally not a grant. They were "put out on deposit"—but never recalled. After the third installment, the surplus—and the "grants"—disappeared in the recession of 1838.

From that date to this only sporadic attention—and no action—has been accorded the general-purpose grant. Yet a whole family of synonyms has been spawned by various observers to identify this form of assistance. Unrestricted, unencumbered, unconditional, general-assistance, untied, no-strings, and block grants are among the candidates for the christening if this blessed fiscal event should one day occur. My own choice is "revenue sharing," mainly to distinguish the proposed financial assistance sharply from our existing grants-in-aid, with "per capita" added to differentiate it from proposals to rebate a share of the income tax to the States of origin.

THE PLAN

In capsule, the revenue-sharing plan would distribute a specified portion of the Federal individual income tax to the States each year on a per capita basis, with next to no strings attached. This distribution would be over and above existing and future conditional grants.

Form and amount of set-aside.—The Federal Government would each year set aside and distribute to the States 1 to 2 percent of the Federal individual income tax base (the amount reported as net taxable income by all individuals). This would mean that, under its existing rate schedule running from 14 to 70 percent, the Federal Government would collect, say, 2 percentage points in each bracket for the States and 12 to 68 percentage points for itself. In 1966, for example, 2 points would have yielded the States $5.6 billion, or 10 percent of the total Federal personal income tax collections of about $56 billion for the year.

The plan would relate the States' share to the Federal income tax base rather than to the income tax revenues, for the following reasons. First, taxable income is somewhat more stable than revenues. Second, since the States' share would be independent of the level and structure of Federal rates, this approach would not create a vested interest in a particular set of rates (though it might do so in exemption levels). Third, for the same reason, it is less likely to interfere with Federal use of the income tax in stabilization policy than a plan keyed to income tax revenues.

Trust fund.—The sums collected for the States would be placed in a trust fund from which periodic distributions would be made. The trust fund would be the natural vehicle for handling such earmarked funds just as it is in the case of payroll taxes for social security purposes and motor vehicle and gasoline taxes for the highway program. It would also underscore the fact that the States receive the funds as a matter of right, free from the uncertainties and hazards of the annual appropriation process. Thus removed from the regular budget process, the revenue-sharing program would be less likely to encroach on the flow of grants-in-aid. Being cast in the form of a flow-through of income tax collections to the States, it would be more likely to come at the expense of income tax reductions.

Distribution of funds.—The States would share the income tax proceeds on the basis of population. Per capita sharing would transfer some funds from States with high incomes—and therefore high per capita income tax liabilities—to low-income, low-tax States. If the modest equalization implicit in per capita sharing were deemed too limited, a percentage—say 10 to 20 percent—could be set aside for supplements to States with low per capita income, or a high incidence of poverty, dependency, or urbanization.

Whether to leave the fiscal claims of the localities to the mercies of the political process and the institutional realities of each State or to require a pass-through to them is difficult to decide. I will examine this issue a bit further on.

Strings.—States would be given wide latitude—nearly complete freedom—in the use of their revenue shares. Without sullying the basic no-strings character of these grants, one would ask the States to meet

the usual public auditing, accounting, and reporting requirements on public funds; one would, of course, apply title VI of the Civil Rights Act; one could even broadly restrict the use of the funds to education, health, welfare, and community development programs—or, at least, provide that they not be spent for highways (which are already financed by a special trust fund). But with the exception of the highway ban, I doubt that such limitations as to functions are desirable in principle since the purpose of revenue-sharing is to enlarge the States' area of fiscal discretion. And, given the fungibility of money, such restrictions would be even less effective in practice.

Those who fear that some States will simply use the revenue shares to rest on their fiscal oars would put in a further condition: that the shares of those States which lowered their fiscal effort would be reduced.

ISSUES AND ALTERNATIVES

The revenue-sharing concept has not lacked for public discussion and for official attention, especially in State houses and in the Halls of Congress. Calls to action are necessarily muted by the heavy fiscal demands of Vietnam. But debate over the merits and limitations of the revenue-sharing approach has not been stilled. It continues in the context of the rapid automatic growth of Federal revenues in an expanding economy—a growth that will involve the declaration of large fiscal dividends in the future—and that may even require special dividends after Vietnam, or in the even happier context of international disarmament.

What commends the revenue-sharing plan to its friends is primarily its simplicity; its provision of a large and automatically growing source of revenue to the States; the freedom of movement it offers the States; the consequent relief from gradual hardening of the categories under the conditional grants program; and its contribution to the vitality and self-determination that will make the States stronger partners in our federalism. Its supporters also cite the equalizing fiscal effects of the revenue-sharing plan and its effectiveness in maintaining a progressive distribution of Federal-State-local fiscal burdens.

Its doubters and detractors express fears that it will drain funds from higher priority national purposes which could be financed directly from the Federal budget; that these funds will go into leaky State purses; that a generous Federal revenue share will lead to a relaxation of State-local fiscal efforts; and that it will not meet the vital needs of local government, particularly in the central cities and metropolitan areas.

Revenue sharing as a source of State-local revenue.—A share in Federal income tax revenues would be a share in the Nation's economic growth. The Federal individual income tax base will reach the $300 billion mark in 1967. So each percent of the base would provide the States with $3 billion (and would cost the Federal Government about 5 percent of its individual income tax revenues). Within 5 years, that amount would grow to roughly $4¼ billion (assuming a 6-percent annual growth in money GNP, and the income tax base growing 20 percent faster than GNP). If the plan were to start at 2 percent, it would channel to the States $6 billion a year, a sum roughly equiv-

alent to one year's growth in State-local expenditures. The competing claims of Federal tax cuts and expenditure increases would probably require that the plan start more modestly (perhaps at one-half of 1 percent or 1 percent) and build up gradually to 2 percent over 3 or 4 years. This gradual buildup would enable the States to program their own fiscal affairs more efficiently.

If 1 percent of the Federal income tax base were distributed in 1967, the grant would be roughly $15 per capita. This would mean, for example, grants of about $30 million for Arkansas, $280 million for California, $30 million for Colorado, $160 million for Illinois, $85 million for Massachusetts, $55 million for Louisiana and Minnesota, $10 million for Montana, $280 million for New York, $75 million for North Carolina, $180 million for Pennsylvania, $15 million for Utah, $65 million for Virginia, and $60 million for Wisconsin.

In order to protect the States against cyclical downturns of revenue, it has been suggested that some sort of safeguard or minimum allotment—perhaps equivalent to the previous year's allocation—be provided in the plan. The trust fund could build up a modest reserve for such contingencies. The postwar experience does not suggest any great need for such a safeguard. In spite of four recessions, the grants under the proposed plan would have risen in every year since 1949. The income tax base, to which the allotments are keyed, has grown from $65 billion in 1946 to $128 billion in 1955, to $210 billion in 1963, and the estimated $300 billion in 1967—and has risen from 31 percent of GNP in 1946 to an estimated 38 percent in 1967.

It also goes without saying—or at least I thought it did—that the Federal commitment to share income tax revenues with the States would be a contractual one, good through thick and thin, through surplus and deficit in the Federal budget. But since privately circulated memordanums have labeled the plan "surplus grants," and pounced on its supposedly fatal flow of being payable only when the Federal Government has a surplus, it is prehaps worth underscoring the obvious in this case. The plan would hardly have its claimed advantages of stiffening and strengthening State and local governments if they were last in the fiscal line, ever fearful that the revenue bounty might suddenly be withdrawn. The very nature of the proposal calls for them to be first in line for their modest share of the income tax, even if it means that the Federal Government has to bear the brunt of periodic deficit financing—which, indeed, it can do much more readily and appropriately than State and local governments.

Although providing significant added support to the States, an allotment of 2 percent of the Federal income tax base would claim only a moderate share of the automatic revenue growth of Federal taxes. Viewing the matter from the perspective of late 1964, before Vietnam so rudely intervened, I visualized as a reasonable allocation of the prospective built-in Federal revenue growth of $35 billion between 1965 and 1970, the following: $5 billion for revenue sharing, $10 billion for tax cuts, and $20 billion for increased Federal spending (including grants-in-aid). This 5–10–20 strategy would have provided substantial and vital relief to the States without impairing the support for Federal functions or ignoring the claims for further tax reduction. Since that day, excise tax cuts, the intervention of Vietnam, and

accelerated expansion and price increases have changed the numbers and the proportions. But the revenue power on which we can draw for such fiscal plans and dreams has grown, not shrunk.

Distributive impact.—Per capita revenue sharing would serve the ends of both political and economic democracy: political democracy, by its contribution—in the form of a reliable and rising flow of funds to the States, free of onerous controls—to a more decentralized and pluralistic society; economic democracy, by helping to preserve a progressive Federal-State-local tax system, to support progressive State-local expenditures, and to promote interstate equalization—in short, by contributing to equality of economic opportunity.

It is politically realistic, I believe, to assume that the revenue shares set aside for the States would absorb funds that otherwise would have gone mainly into Federal income tax reduction and partly into Federal expenditure increases. It would transform them mainly into increases in State-local expenditures and partly into a slowdown of State-local tax increases.

With expenditure demands on State and local governments rising by 7 to 8 percent a year, the fiscal dividends from the Federal Government would not often go into tax reduction. And if, in part, they did result in slower increases in sales, property, and excise taxes—or even in an occasional cut in such taxes—I do not view this as original fiscal sin. Who is prepared to say that slowing down the reduction of the progressive and relatively equitable Federal income tax in order to relieve pressure on regressive, inequitable, and inefficient property and consumer taxes is a bad trade? Dollar for dollar, substituting lower state-local taxes for cuts in Federal taxes would increase the progressivity of the tax system—and benefit the economy by the relative shift away from taxes that bear unevenly on consumers and heavily on business costs. Full use of the shared revenue for higher State-local expenditures would, of course, have an even more progressive effect since their benefits are heavily weighted toward the lower income groups.

Detailed statistical estimates of the distribution of tax burdens and expenditure benefits at the Federal and State-local levels bear out these conclusions. State-local tax burdens rise gently with income in the lowest income brackets—from an estimated 12 percent of family income below $2,000 to 18 percent in the $4,000 to $5,000 income bracket. But from there on up the income scale, they regress with a vengeance—dropping to 6 percent on incomes of $10,000 and over. Property and sales taxes are, as expected, the villain of the piece, taking an estimated 17 percent of income in the $4,000 to $5,000 bracket, but plunging to only 4 percent for incomes over $10,000. Federal tax burdens, in contrast, run from 18 percent of family incomes below $2,000 to 31 percent over $10,000 (though not without a surprising dip for incomes between $5,000 and $10,000).

Both Federal and State-local expenditures are progressive in their incidence ("progressive" here meaning that they benefit the lower income groups more than the higher). The State-local expenditure pattern is strongly so, declining steadily from an estimated 43 percent of income for the poorest families to 6 percent for families with incomes above $10,000. The ratio of Federal expenditure benefits to

income also drops as income rises, but less sharply and steadily: from 42 percent of the poorest incomes to 17 percent of incomes over $10,000.

These estimates are subject to important limitations of data and concept. Yet study after study has confirmed the unmistakable pattern of substantially progressive Federal taxes and expenditures, strongly regressive State-local taxes, and strongly progressive State-local expenditures. They settle no questions of social priority or of efficiency in taxing and spending. But they leave no doubt that a shift of revenues to the States and localities would make our overall fiscal system more progressive.

Interstate equalization.—Per capita revenue sharing would have a significant interestate equalizing effect, an effect that could readily be magnified by simple adjustments in the sharing formula. As already noted distributing 2 percent of the individual income tax base in 1967 on a straight population basis would return $30 per capita to all of the States. Yet the 2 percent would draw $42 per capita from the 10 richest States and only about $18 from the 10 poorest (using 19?4 Internal Revenue Data adjusted to the projected $300 billion income tax base in 1967).

This, by the way, gives us a measure of the difference between per capita revenue sharing and sharing on the basis of origin. The latter would return the same $42 to the richest States and $18 to the poorest States that came from those States. In this respect, the Federal crediting device—credits against Federal tax for State income taxes paid—is similar to sharing the income tax on the basis of origin.

In contrast, conditional grants-in-aid lend themselves to formulas that can take fiscal capacity into account. A number of the functional aid programs provide larger unit grants to the low-income than to the high-income States. But aggregate data on Federal aid are a disappointment on this score. For example, in 1964, Federal grants (including highway grants) to the 10 lowest-income States averaged $58 per capita, to the 10 highest, $85 per capita. As a percentage of State-local general revenues, the grants represented 21 percent for the 10 lowest-income States and just under 20 percent for the 10 highest. These figures suggest that even though individual programs may have an equalizing effect, the overall impact is not equalizing unless one takes into account the geographical incidence of the Federal taxes from which the grants are financed.

As suggested earlier, the per capita formula could be adjusted to take special account of the urgent needs of the poorest States. If as little as 15 percent of the total funds were to be set aside for distribution to the lowest income third of the States, it would mean raising the grant to the poorest State by perhaps 2½ times the amount that it would get from the straight per capita formula. The easy adaptability of the revenue-sharing plan to almost any preference as to equalization among the States can be an important asset.

State-local tax effort and Federal tax credits.—Some misgivings have been expressed about the revenue-sharing plan on grounds that it contains no spur to greater State-local tax effort and might even encourage the States to relax their fiscal efforts. In the preceding section I have suggested that the distributive implications of some letup in fiscal effort would not be unfavorable. But this is not to say that

greater effort, and particularly greater equality of effort, should not be encouraged.

The revenue-sharing formula could be modified to take account of fiscal effort and thereby not only discourage backsliding but provide a positive stimulus to greater and more equal tax effort. "A simple and effective way of allowing for effort would be to weight the per capita grants by the ratio of State to average tax effort in the country, where tax effort is defined as the ratio of State-local general revenues to personal income" States whose tax efforts are below par or who cut their taxes in response to the Federal subsidy would be penalized by reduction in their allotments. States making a high fiscal effort or intensifying that effort would be rewarded with larger allotments.

Under the suggested measure of effort, as it would have applied in 1964, Louisiana, New Mexico, and North Dakota had effort indexes of 120 or above. Eleven other States had indexes of 110 or more: Arizona, California, Hawaii, Idaho, Minnesota, Mississippi, Montana, South Dakota, Washington, Wisconsin, and Wyoming. At the lower end, nine States had an effort index of only 85 or less: Connecticut, Delaware, Illinois, Maryland, Missouri, New Jersey, Ohio, Pennsylvania, and Virginia.

Since such an effort index would make inroads on the simplicity of the plan, one is somewhat loath to recommmend it. Without it, however, the plan would have to concede superiority on this score to the tax crediting device. The excellent proposal for an income tax credit advanced by the Advisory Commission on Intergovernmental Relations in 1966 effectively demonstrates this advantage. Under its proposal, the taxpayer would be allowed to credit against his Federal individual income tax liability a substantial percentage—40 percent seems to be the preferred rate—of his State income tax payments. (Taxpayers in the very high brackets, for whom deductibility of the State tax against the Federal taxable income provides a larger tax saving, would retain such deductibility as an alternative to the credit.) The Commission's tax credit plan would put substantial funds at the State's disposal—about $800 million a year at today's tax rates, with a maximum of perhaps $3.5 billion a year in the foreseeable future as the credit led to more widespread and intensive use of the income tax by the State.

The Commission recommendation is an ingenious variation on income tax credit ideas that go back many decades. In the more traditional form, the credit would be taken—as in the case of the estate tax—as a specified proportion, say 10 percent, of the Federal tax, and no more. The effect of this more traditional plan is to relieve the tax payer of all State tax liability up to the stated percentage of the Federal tax, and none above that point. The Commission plan has the great attraction of being open-ended. No matter how high the rates of a State income tax may be pushed, 40 percent of that tax is, in effect, automatically paid by the Federal Government in the form of a tax offset.

The major attractions of the Commission's tax credit plan are that it would not only put large sums into the States' hands to be utilized entirely as they see fit, but would give them a major incentive to use our best form of taxation. But the plan is also subject to some limitations.

First, unlike the revenue-sharing plan, a considerable part of the tax credit in the 33 income tax States would initially be a direct benefit to the taxpayers rather than to their governments—though this initial relief would eventually be dwarfed by higher tax liabilities if the credit had its intended stimulative effect.

Second, as noted above, the tax crediting device provides no interstate equalization of fiscal burdens.

Third, the plan faces the tough pragmatic barrier that 17 States at present have no income tax, some of them because of seemingly stubborn constitutional prohibitions. This barrier, more than any other, has kept the tax credit idea languishing in textbooks, monographs, and doctoral theses (including my own of 25 years ago) for many decades. Although the tax credit is meant to offer the States an enlightened helping hand, some of them will regard it as coercion rather than cooperation.

Many of us, I am sure, share the underlying conviction that the States should be making far more use of the income tax—particularly the personal income tax—than they are today. In addition to the 17 States without income taxes, 12 impose a tax that amounts to less than 1 percent of Federal adjusted gross income; another 12 have income tax burdens under 2 percent; and only nine have effective rates, in this sense, of over 2 percent—ranging to a maximum of over 3 percent in Delaware, Oregon, and Wisconsin. A form of Federal fiscal support which would lead the States into these green pastures of growth and progression that they are now so widely neglecting has an understandably strong attraction.

States seeking broad grants derived from the Federal income tax should ask whether their case may not suffer from having such a spotty record in their own utilization of this excellent source. Some of the advocates of the income tax credit have argued that it would induce (a much nicer word than "coerce") the States into a stronger position to lay claim to a share of Federal income tax revenue. Indeed, in the best of all worlds, one would hope to be able to afford both the income tax credit and revenue sharing. If a choice has to be made, the balance of advantages seems to favor the revenue-sharing plan. But the income tax credit would be a major advance in Federal-State fiscal relations, a very good second best. Those of us who labor in the vineyards of Federal-State fiscal relations should take care that the good becomes the handmaiden, not the enemy, of the best.

The claims of local governments. Per capita revenue sharing would miss its mark if it did not serve to relieve some of the intense fiscal pressures on local governments, especially in urban areas. The question is whether this relief would come automatically from a no-string grant, or whether a specific part of the trust fund should be reserved for the local units.

The case for leaving this to the discretion of the States is based on several rather persuasive arguments. Directing that a specified percentage or amount should go to the localities might encumber the plan with the rigidities it is designed to avoid. States differ greatly in their division of responsibilities and finances between State and local governments. In some States as much as two-thirds of total State-local expenditures may be financed by the State government. In other

States the opposite ratio may apply. Arrangements for States aids and shared taxes differ greatly, and there are substantial variations in the division of functional responsibilities as well.

At the same time it is true that all States, in one way or another, raise sizable amounts of revenue for their local subdivisions. Over half of the general expenditures of the States takes the form of transfers to local governments. The States supply something like two-fifths of the funds spent by local governments for education. All told, nearly a third of local general revenues comes from the States. Small wonder, then, that we typically hyphenate "State-local." We have little reason to fear, I believe, that the shared income tax revenues would simply be bottled up at the State level. This does not, of course, resolve the question whether *enough* would pass through to local, and especially urban, units of government.

Here, as an article of faith, I count rather heavily on reapportionment to achieve equity in the allocation of funds within the States. Yet I do not wish to say that reapportionment, for all its good works, is a guarantee of the balanced distribution of Federal funds. Central cities will be represented in proportion to their population but not to their problems. For their crushing problems of poverty, racial disability, obsolete social capital, and public services cannot be solved within their own bounds. They require recognition—and financial help—on a metropolitan-area, a State, and a National basis. The danger that growing suburban representation under reapportionment will still leave State legislatures unsympathetic to the problems of the core cities argues for some adjustment in the allocation formula to give special recognition to their needs.

Indeed, were it possible, one would want to recognize the attractions of both metropolitan area and regional approaches to the solution of governmental problems by some form of special stimulants in the allocation formula. Yet, if the revenue-sharing plan is to retain its advantages of flexibility—the freedom to put funds to the neediest uses as each State sees them—then the less arbitrary and fixed the pattern of distribution, the better. Perhaps the special claims of urban areas, metropolitan government, and regionalism will have to be subjects of special programs such as the Appalachia regional development program, the proposed demonstration cities program, and the community action programs under the Economic Opportunity Act.

One possibility in the revenue-sharing arrangement would be to put a floor under the pass-through to the States and localities by specifying that no less than the present ratio of State financing of local services be maintained. The Javits bill meets this problem by requiring that the States must distribute to their local governments an equitable proportion of their allotments—the ratio in each State is to be no less than the average of the State's distribution of its own revenues to local governments over the previous 5 years. Again, of course, in attempting to enforce such a provision, one faces the perennial problem of fungibility: the States might dutifully conform to the pass-through requirements of the revenue-sharing law and simultaneously reduce other payments to the local governments.

The pass-through issue is a perplexing one. Seemingly persuasive considerations can be brought to bear on both sides of the question.

How to give special weight to the claims of central cities and metropolitan areas, yet not freight the formula with too many conditions, remains a challenge to ingenuity.

National purpose. However one might resolve the important questions of distribution, equalization, tax effort, and pass-throughs, one has to come back to the jugular question of the impact of the revenue-sharing or general-assistance grants on the fabric of federalism. Would the national purpose—the quest for a physical and social environment that will enhance the life of man—be served well or ill? Would we, as some think, be playing into the hands of waste and corruption, or would efficiency and better government be the outcome? and finally, would the vitality and quality of the States—and hence the strength of federalism—be sapped or strengthened?

Some critics fear that turning revenues over to the States without Federal controls would sacrifice national priorities, drain funds away from high-priority education, urban renewal, and mass housing programs toward low-priority uses. This danger is, I believe, greatly overrated.

Not only is the proposed revenue share small in relation to the total Federal budget, but even at the $6 billion level, it would be less than 1 year's automatic growth in Federal revenues. And in the form of a direct collection of a specified share of the income tax on the States' behalf, routed through a trust fund, the aid to the States would, as already noted, come chiefly at the expense of income tax cuts, not Federal civilian programs.

Further, the defenders of these programs have some impressive advantages in the battle for funds. Federal organization, whether in the executive agencies, in the budget process, or in the congressional committee, is largely along functional lines. Private interest groups and pressures operate along the same lines. Speak of schools, highways, farm subsidies, or health programs—and groups in the administration, Congress, and private life spring to the colors and man the budgetary battle stations.

But speak of bolstering and revitalizing State and local governments, and who listens? Or, at least, whose attention span goes beyond a day or two? What troops can State-local governments command in the political and fiscal wars? Few enough, even with the welcome new emphasis on creative federalism, to lead me to believe that general-assistance grants would be but a minor threat to either the well-fortified positions or the further conquests of the functional programs. This is not to say that these programs have things all their own way, that they get all the money they need. But I doubt that revenue sharing would drain funds from them. Indeed, it would better equip the States to hold up their end of the job, both in the broad sense of making them more effective units of government and in the narrow sense of enabling them to meet the matching requirements of the functional grants. In other words, minimum-strings assistance to the States would serve, not thwart, the national purpose.

This conviction is strengthened by even a brief review of the uses to which the States have, in recent years, put added funds (85 percent of which, one should recall, come from their own sources). Of the $37 billion increase in expenditures of States and localities from 1954 to 1964,

41 percent went into education. Another 14 percent of the increase went into health and welfare. Highways took 16 percent; police, fire, and sanitation, 8 percent; natural resources and community development, 4 percent. Only 3 percent of the increase went for general administration; 4 percent for increased service on debt; and 10 percent for other purposes.

Most striking about this list is that—even before long-overdue general school aid was coaxed out of Congress by President Johnson in 1965—the States and localities put their greatest single effort into education. Who would fault them on this sense of priority? But let me move from defense to offense. Vital as the Great Society programs are in turning abundance to the Nation's good, it does not follow that government's contribution to the good life comes exclusively with a "Made in Washington" label. Many of the seemingly humdrum functions of State-local governments, undertaken with little or no Federal help, come pretty close to the heart of our national purpose. Police protection and law enforcement, elementary sanitation, recreation facilities, street maintenance and lighting—things that, together with housing and schooling, spell the difference between a decent and a squalid environment, a respectable neighborhood and an explosive ghetto—are cases in point. We neglect them at our peril.

Efficiency and honesty. Aside from the question of priorities, critics charge that State-local government is so often inefficient, wasteful, and corrupt that it is unworthy of anything but tightly controlled Federal support. The issue of honesty and efficiency takes both crude and subtle forms.

In its crudest form, the charge is that many State legislatures are dominated by corrupt, venal, and interest-ridden buccaneers; that State administrations are weak and incompetent; that local government is archaic in structure and poorly managed. On each point one has to begin by granting that horrible examples can be found to fit each of these charges, and that State and local governments have not done nearly enough to overcome obsolete structure and ineffective administration.

But we must be careful not to condemn by cliche. Not only does reapportionment promise better balance and new blood in legislatures—and hence fairer and more intelligent allocation of funds—but the picture of administrative incompetence is greatly overdrawn. As one keen observer put it after mingling with Governors and their staffs for several days at the National Governors' Conference, "The great majority of the Governors . . . are dedicated, hardworking, and above all, highly competent individuals, handling complex administrative and policy problems that would overwhelm many a Senator." He went on to say that "for the most part, too, these men are surrounded by trained, talented staffs, not mere political cronies and hangers-on."

Part of the answer to the critics must be found also in the basic objective of general-purpose grants. It is precisely to enable the States to overcome some of their weaknesses that broad gaged grants are so badly needed. Denying the States such assistance would perpetuate the evils that are not simply in the eye of the beholders.

Revenue sharing could contribute to efficiency by relaxing the ever-tighter grip of special-purpose aids. True, these aids have created

islands of personnel competence and administrative efficiency. Nonetheless, with over 80 special-purpose grants now in force the system not only becomes complex and uncoordinated, but also tends to interfere with an efficient allocation of public funds, especially in poorer States. Under the whiplash of matching, funds may be driven away from nonaided but possibly higher priority, and hence more efficient, uses. To avoid an inefficient allocation of State-local funds, our system of tightly tied aids needs to be flanked by wide-latitude grants like those provided by revenue sharing. The Federal aid system would thereby gain in balance and rationality, and the States would gain in efficiency and freedom of choice.

Some fears of inefficiency rest on grounds, not that the vessels into which Federal funds would be poured are cracked and leaky, but that moneys flowing in without the pain of self-taxation or the penalty of Federal controls would be spent like water. Yet it is difficult to see why the proposed sharing of revenues with the States should promote loose spending. First, the Federal funds, unmarked by any radioactive tracers, would be commingled with State and local funds. Second, they would cover only a modest percentage of the cost of any given program; the bulk of the funds would be the community's own hard-earned tax money. Third, since the flow of receipts each year would be fixed, there would be none of the incentive to profligacy that arises when the spender knows that "there's always more where that came from." All told, there is little reason to believe that States and localities would spend the money less wisely, efficiently, and responsibly than funds from their own sources.

One of the false issues of efficiency that besets the debate is the perennial charge that channeling Federal funds to the States increases government costs by "the additional freight of a round trip to Washington." This charge would hardly merit serious debate were it not such a stubborn weed in the garden of fiscal coordination. Yet it should wither before the facts. First, costs of collecting Federal taxes are far below costs of collecting State and local taxes. Second, given vast advantages in jurisdiction, size, and scale, the Internal Revenue Service is an inherently more efficient tax administering agency than those of the States. Third, with respect to plans like revenue sharing, there would need to be no new machinery and no added administrative costs of any consequence. The round trip to Washington would cost less than a round trip to the State house or city hall. On these, admittedly narrow, efficiency grounds, the flowthrough of Federal income tax funds to the States would get high marks.

In view of the Federal Government's vastly superior taxing power and efficiency—in taxation, the whole *is* greater than the sum of its parts—why not turn over the entire taxing job to it? The obvious answer is that State-local government would then be completely dependent on the power of the Federal purse. As citizens, we are willing to pay a considerable premium for independent taxation as a cost of self-government at the State-local level. At the same time we seek the strength which can come from alloying such taxation with Federal grants that share the revenue bounties of prosperity with the governments which bear its burden.

Revitalizing the States. Transcending all other considerations, as we seek new forms of Federal fiscal relief for the States, is the need

not simply to increase their resources but to restore their vitality; not simply to make them better "service stations" of federalism but to release their creative and innovative energies; not simply to pay lipservice to "States' rights" but to give substance to local self-government.

State and local officials need a chance to worry, not just about getting the dead cat out of the alley—as Daniel Hoan, the socialist mayor of Milwaukee, once characterized the first demand on him after he had been elected to the exalted post of mayor—but about how we can more effectively devote our growing abundance to our common needs, how we can get at the roots of our social failures. They need an opportunity to worry not just about where the next dollar is coming from but what the world is coming to.

Money alone won't do it. We should not fall prey to what Senator Kenneth Keating once called "the Washington reflex," the tendency "to discover a problem and then to throw money at it, hoping that it will somehow go away." Some $14 billion of functional aids are serving high national purposes, but they have not made our State-local fiscal malaise go away. Nor is it likely to go away until we change the form and terms in which we furnish new Federal funds to the States.

Revenue sharing, or similar general-purpose grants, could supply the missing fiscal link. On one hand, the funds would not be tied to specified national interests, bound by detailed controls, forced into particular channels, and subject to annual Federal decisions. On the other, they would not have to be wrung out of a reluctant State-local tax base at great political risk to bold and innovative Governors and legislators. In short, revenue sharing would provide a dependable flow of Federal funds in a form that would enlarge, not restrict, the options of State and local decisionmakers.

One readily visualizes the tangible benefits: higher salaries and hence higher caliber staffs; better performance of the jobs the Federal Government subcontracts to States and localities; and a more effective attack on problems beyond the reach of Federal projects and the present system of Federal aids.

But the intangible gains are even more promising. General-assistance grants would offer relief from the intense fiscal pressures that lead to default and dependence; would help the Nation tap not only the skills and knowledge but the wisdom and ingenuity of our State and local units; and would enable these units to flex their muscles and exercise greater discretion and responsibility. It would help them hold their heads high and fulfill their intended role as strong and resilient partners in our federalism.

The revenue-sharing plan, indeed the whole general-assistance approach, has been criticized from one side as too conservative and from the other as too liberal. It is said to be too conservative in that it interrupts the march of history toward centralization, toward increased power and responsibility for a Federal Govrenment which is efficient and well equipped to promote the national interest. Strengthening the States, in part at the risk of retarding the growth of Federal programs, is said to be a retrograde step.

It is said to be too liberal because it would redistribute some funds from higher to lower income groups by drawing them from the pro-

gressive Federal income tax and channeling them, through State budgets, largely into education, health, and welfare; and because it would levy more heavily on the wealthy States and share more generously with the poorer States.

But we can turn both of these points to the defense of revenue-sharing or similar plans: they combine the sound conservative principle of preserving the decentralization of power and intellectual diversity that are essential to a workable federalism with the compassionate liberal principle of promoting equality of opportunity among different income groups and regions of the United States. In turning these arguments to advantage, I am reminded that one dare not be any more doctrinaire on the political economy of federalism than on the political economy of stable prosperity.

I have been making a general case in terms of a particular plan. I believe that the plan would go to the heart of the fiscal problem of our federalism. But let me stress again that it is the general case, not the particular plan, that matters. The important thing is to be ready to move from talk to action once Vietnam relents—to harness Federal funds to State-local initiative as part of the national undertaking to convert economic growth into a better life. The good life will not come ready made, from some Federal assembly line. It has to be custom built, engaging the effort and imagination and resourcefulness of the community. Whatever fiscal plan is adopted must recognize this need.

No single fiscal plan can move the mountains back to Mohammed. But it will not be working alone. Other earthmoving, possibly even earth-shaking, forces are already at work. Reapportionment has already realined 35 legislatures. New demands flooding in on the States and localities are stirring new efforts at administrative and legislative reform. A growing sense of social corrosion and crisis—of which Watts and Harlem and Chicago's South Side are explosive examples—is awakening a new sense of State and local responsibility. And sustained prosperity is opening new vistas of fiscal hope. New Federal efforts to stiffen the State-local fiscal spine would be made in the context of important forces already gathering for a renaissance of the States.

And here the linkage between the potential of our economy and the potential of our federalism comes into clear focus. The steps we take to strengthen the fiscal base of our federalism—partly by expanding and improving the existing system of Federal grants, partly by building on emerging institutions like the community action and Appalachia programs, and partly by developing new devices like revenue sharing—are all elements of a design to use our growing mastery of the economic environment to master also our physical and social environment. That design can give substance to the promise that our growing abundance will indeed be used "to serve our ultimate social objectives in a framework of freedom."

FINANCING STATE AND LOCAL GOVERNMENTS*

BY JOSEPH A. PECHMAN

Mr. PECHMAN. Expenditures of the States and local governments have grown rapidly in recent years, and will continue to grow rapidly in the foreseeable future. These governments are already spending more than $70 billion per year; they will be spending more than $100 billion in 1970. The rise in State-local spending reflects the demands of an expanding population for more and better public services. These demands have strained the fiscal resources of the States and local governments, and they have responded with an unprecedented tax effort. Nevertheless, the need for State-local services will increase faster than State-local revenues.

In the past, State and local needs have been met in part by Federal grants-in-aid for particular purposes. These specific Federal grants have helped to finance programs in which the national interest was particularly strong. But it is now clear that the States and local governments also need help to meet the needs of their citizens in areas of traditional State-local responsibility.

Until recently, the Federal Government has not been able to provide general assistance to the States and local governments, simply because it has had rapidly growing commitments for defense and defense-related programs. But the pressure for larger expenditures for these Federal activities seems to have abated. Unless the Federal Government takes on new responsibilities, it now seems likely that its potential revenues at present tax rates will increase more rapidly than its expenditures. This prospect provides the opportunity for consideration of methods of helping the States and local governments out of their fiscal plight.

This paper discusses the reasons why the States and local governments need assistance, examines several methods of providing such assistance, and suggests the outlines of a new approach that seems worthy of further exploration.

STATE-LOCAL NEEDS AND FISCAL RESOURCES

The burdens placed on State and local governments in the past two decades have been extraordinarily heavy. They found themselves at the end of World War II with a large backlog of unmet needs; and rapid population growth has added new demands on top of this backlog. Between 1953 and 1963, the school-age population (those 5 to 19) rose 40 percent while the total population increased only 19 percent.

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In the same period, the number of persons over 65 increased 35 percent. Thus, the age groups which require the costliest Government services and contribute least to the tax base—the old and the young—increased much faster than the rest of the population.

The problems of population growth were aggravated by mobility. People moved freely from State to State and from region to region in the search for new jobs and better living conditions. They migrated from the rural to the urban areas, and left the central cities for the suburbs. New communities were developed while others were being abandoned. New schools, roads and sewers, and more teachers, policemen, firemen, and other personnel were urgently needed in most parts of the country. As a result, the largest "growth industry" in the United States has been State and local government.

The story of how the States and local governments tried to meet the challenge of growth has been told many times. I shall review it briefly here as background for the discussion of the fiscal problems it has created.

RECENT EXPANSION OF STATE-LOCAL EXPENDITURES

In the 10 years ending in 1963, annual State-local expenditures for general governmental purposes (current operations, capital outlay, and interest on debt) more than doubled, rising from $28 billion to nearly $65 billion. About 53 percent of the increase went for education, health, and welfare (table 1).

TABLE 1.—*General expenditure of State and local government, by major function, fiscal years 1953 and 1963* [1]

[Dollar amounts in millions]

Function	Amount		Increase 1953–1963		
	1953	1963	Amount	Percent distribution	Percent increase
Total general expenditure	$27,910	$64,816	$36,906	100.0	132.2
Education	9,390	24,012	14,622	39.6	155.7
Highways	4,987	11,136	6,149	16.7	123.3
Public welfare	2,914	5,481	2,567	6.9	88.1
Health and hospitals	2,290	4,681	2,391	6.5	104.4
Police and fire	1,636	3,468	1,832	5.0	112.0
Natural resources	705	1,588	883	2.4	125.2
Sewerage and sanitation	908	2,187	1,279	3.5	140.8
Housing and community redevelopment	631	1,247	616	1.7	97.6
General control and financial administration	1,263	2,474	1,211	3.3	95.9
Interest on debt	614	2,199	1,585	4.3	258.1
Other	2,572	6,343	3,771	10.2	146.6

[1] Excludes insurance trust, liquor stores, and public utility expenditures. Includes Federal grants-in-aid.

Source: Bureau of the Census.

Most of the expenditure increase reflected the need to provide services for the large increase in population, but price increases also played an important role. Equipment and construction costs rose rapidly. Salaries of teachers and other Government employees had to be brought into better alinement with salary levels in the private economy. Even moderate adjustments in compensation involved large ex-

penditures, since personal services constitute a large part of State-local budgets.

While State-local outlays increased everywhere, the level of expenditures varies greatly in different States. For example, in fiscal year 1963, the five States with the lowest per capita income spent $262 per capita for State-local services, while the five States with highest per capita income spent $417 per capita, and this despite the fact that the five poorest States made a larger tax effort (as measured by the ratio of State-local general revenues to personal income) and received more Federal aid per capita than the five richest States. In fiscal year 1964, expenditures per pupil in average daily attendance in public elementary and secondary schools were over $550 in four States, but less than $350 in nine States. Average monthly payments to families with dependent children in June 1964 varied from less than $20 per recipient in six States to more than $40 in 11 States. These wide variations in expenditure levels indicate that deficiencies are far more serious in some parts of the country than in others.

The available expenditure figures reflect amounts spent and not amounts that would have been spent if adequate resources had been available to finance a level of services consistent with need. Satisfactory measures of the degree to which State-local expenditures fall short of need are not available, but many of the deficiencies are obvious: overcrowded classrooms, inadequate health and hospital facilities, poor housing, blighted areas with high levels of juvenile delinquency, clogged streets, and polluted air and water. These deficiencies are all the more glaring against the background of rapidly rising private consumption standards.

SOURCES OF FUNDS

Federal grants to State and local governments tripled between 1953 and 1963 (from $2.9 to $8.7 billion), but this increase accounted for only 16 percent of the $35 billion increase in State-local general revenues. The remaining 84 percent—close to $30 billion—was raised from their own sources (table 2). State-local tax collections increased by $23 billion, or 111 percent during this period (while Federal collections increased by $24 billion, or only 38 percent). State-local debt rose from $34 to $87 billion (table 3).

Almost the entire increase in local tax collections and 46 percent of the combined State-local increases came from higher property tax revenues. While new construction and higher property values contributed significantly to the property tax base, tax rates were increased substantially. In many cities and towns, property tax rates are already too high and further substantial increases in these rates are undesirable.

Consumer taxes provided 32 percent of the 1953–63 increases in State-local tax collections; income taxes provided only 9 percent. These revenue increases also came in large part from the higher incomes and increased spending made possible by economic growth, but new taxes and increases in the rates of old taxes were important contributors. Since 1952, five States have entered the general sales tax field, and two-thirds of the 33 States with general sales taxes in 1952 have raised their rates (some two or three times during this

TABLE 2.—*General revenues of State and local government, fiscal years 1953–63*

[Dollar amounts in millions]

Source of increase	Amount		Increase 1953–63		
	1953	1963	Amount	Percent distribution of total increase	Percent distribution of tax increase
General revenue [1]	$27,307	$62,890	$35,583	100.0	
Revenue from Federal Government [2]	2,870	8,722	5,852	16.4	
General revenue from own sources	24,437	54,169	29,732	83.6	
Taxes	20,908	44,281	23,373	65.7	100.0
Property	9,375	20,089	10,714	30.1	45.8
Sales and gross receipts	6,927	14,456	7,529	21.2	32.3
Individual income	1,065	3,269	2,204	6.2	9.4
Corporation income	810	1,505	695	1.9	2.9
Other	2,731	4,962	2,231	6.3	9.6
Charges and miscellaneous	3,529	9,888	6,359	17.9	

[1] Excludes revenue from publicly operated utilities, liquor stores, and insurance trust systems.
[2] Includes in addition to direct grants-in-aid, shared revenues, amounts received from the Federal Government for contractual services, and payments in lieu of taxes. Excludes grants in kind (distribution of commodities, technical assistance, etc.) and net loans and repayable advances.

NOTE.—Because of rounding, detail may not add to total.

Source: Bureau of the Census.

TABLE 3.—*State and local government debt, fiscal years 1953–63*

End of fiscal year	Debt outstanding	
	Amount (millions)	Index (1963=100)
1953	$33,782	100
1954	38,931	115
1955	44,267	131
1956	48,868	145
1957	53,039	157
1958	58,187	172
1959	64,110	190
1960	69,955	207
1961	75,023	222
1962	81,278	241
1963	87,451	259

Source: Bureau of the Census.

period). Nineteen States now have 3 percent sales tax rates and eight States have rates in excess of 3 percent. Only two States have enacted new individual income taxes since 1949, but tax rates have been raised in most of the other 31 States with income taxes. Income tax rates have been increased most at the lower income levels, and the degree of progressivity has declined. Local governments in several States have moved into sales and payroll taxes; and many States and localities have introduced new taxes on business activities, many of them of the nuisance variety.

OUTLOOK FOR THE FUTURE

The fiscal pressure on the States and local governments shows no sign of easing. Although these governments have made great efforts

in the past decade, serious deficiencies remain and new needs will be created by continued population growth, increasing urbanization, and rising expectations. There is little doubt that without substantial assistance from the Federal Government, State-local revenues will fall far short of their expenditure needs. The basic problem is that needed State-local expenditures rise faster than gross national product, while State-local taxes, unlike Federal taxes, are relatively unresponsive to economic growth.

The magnitude of the problem may be roughly illustrated by the following projection. Suppose gross national product grows at 5 percent per annum and State-local receipts (including Federal grants) keep pace with this growth. On these assumptions, State-local receipts would reach about $88 billion by 1970. But if needed State-local expenditures grow at 7 percent per annum—which seems conservative in the light of past experience—they would reach $103 billion by 1970, leaving a gap of about $15 billion.

In the absence of additional Federal aid, the States and local governments would have to raise their tax rates to fill this gap of $15 billion. But this is hardly likely to occur. In every State and municipality, fear of driving commerce and industry to competing jurisdictions or of discouraging the entry of new businesses restrains new and increased taxes. Recent elections in many States demonstrate the political hazards facing elected officials who support tax increases. Furthermore, from the standpoint of tax equity and economic policy, it is undesirable to finance these long-run requirements almost entirely by property and consumer taxes—the revenue sources on which State and local governments largely depend.

In brief, the States and local governments cannot—and should not—meet all of their foreseeable revenue needs from the revenue sources now available to them. Given the present division of functions and of revenue sources, it is a matter of national concern that many essential government services may not be provided because of the inadequacy of State-local financial resources.

The Federal Budget Outlook

By contrast with State-local receipts, Federal receipts rise rapidly as the economy expands because they are based largely on personal income and corporate profits. With continued economic growth, Federal budget receipts will grow about $6 billion per year in the next 5 years. At the same time, defense expenditures seem more likely to decline a bit than to increase (unless, of course, international conditions worsen), and expenditures for space exploration will probably level off. This means that a dividend of $6 billion will probably be generated each year for nondefense purposes, or a total of $30 billion for a 5-year period.

The availability of such a dividend is a blessing only if it is used wisely. Recent experience suggests that the rate of private saving will exceed the rate of private investment. For this reason, it will not be good economics to allocate a substantial part of the dividend, if any, to debt retirement. Further tax reduction and/or expenditure increases will be needed to avoid an increase in unemployment. Indeed,

unless the dividend were used in this way, it would probably not be available at all. Efforts to hold down expenditures while maintaining tax rates would add to the fiscal drag that has already made the achievement of full employment so difficult.

The remedy is to continue to maintain a fiscal policy that stimulates demand if the private economy is not strong enough. This can be done either by reducing taxes or by increasing expenditures for needed Government services. The difference is that tax cuts favor private spending, while expenditures increase investment or consumption in the public sector. It is important to note that public spending need not be at the Federal level. Even though the revenues are Federal, they may be used in part to finance State-local public services.

In the present circumstances, there are too many pressing public needs to justify reliance on tax reduction as the sole mechanism of eliminating the fiscal drag. Some portion of the growth of $30 billion in Federal receipts over the next 5 years will doubtless be needed to finance growing Federal activities. Since so many of the public needs are within traditional State and local responsibilities, it would also be in the national interest to use part of the $30 billion to help finance the more rapidly growing State-local activities. In fact, unless inflationary pressures develop, there will be room in the Federal budget for increased Federal expenditures and additional assistance to the States and local governments, as well as for some tax reduction.

Alternative Methods of Assisting State and Local Governments

There are many possible ways to help the States and local governments. In choosing among them, most people will agree that we should be guided at least by the following three criteria: First, the amount of assistance should be large enough to make possible a significant increase in the level of State-local services; second, the funds should help to equalize the services available to citizens of different States; and, third, the plan should not reduce the progressivity of the total Federal, State, and local tax system.

The most frequent proposals for accomplishing these objectives involve reduction of the Federal tax take. They include: (1) Federal tax reduction to enable the States to raise their own taxes; (2) relinquishment of specific Federal taxes; (3) tax credits for State and local taxes against Federal taxes; and (4) sharing of Federal tax collections with the States. In addition, suggestions are made to expand Federal grant programs of the type now existing or adding new ones. As the following discussion will indicate, the four tax alternatives fail, in varying degree, to meet the criteria for an appropriate method of fiscal assistance to the States and local governments.

FEDERAL TAX REDUCTION

A reduction of Federal taxes does not, in the first instance, have any effect on the fiscal resources of the States and local governments. State-local receipts would increase indirectly as a result of the effect of the Federal tax cut on the national income, but this would be only a small fraction of the revenue released by the Federal Government.

The State legislatures and county and city councils would have to take positive action to pick up the remainder of the lost revenue. Although some of this will occur, there is little likelihood that all of the lost Federal revenues will find their way into the budgets of the States and local governments.

Furthermore, to the extent that State-local taxes increase, they will be largely of the sales or property tax variety. These taxes are already overworked and are regressive besides. From the standpoint of tax equity, there is nothing to commend the replacement of Federal income taxes by State and local sales and property taxes.

RELINQUISHMENT OF FEDERAL TAXES TO THE STATES

Relinquishment of one or more Federal taxes in the hope that the State and/or local governments will pick them up is also not a practical alternative. State and local governments find it difficult to move into an area vacated by the Federal Government, because of local opposition to tax increases and fear of interstate competition. Past experience with the admissions tax and the electrical energy tax has indicated that reduction or elimination of a Federal tax is not necessarily followed by State and local adoptions. Local governments had long sought reduction or repeal of these taxes on the ground that they were particularly suitable for local use. Following repeal of the Federal electrical energy tax and drastic reduction of the Federal admissions tax, local governments did not make the anticipated use of these taxes. Similarily, it is doubtful that the States and local governments will pick up more than a small proportion of the reduction of Federal excises which will soon be considered by the Congress.

The response of the States and local governments to the release of any tax by the Federal Government is bound to be spotty, because it depends on action by many separate executive and legislative bodies. Moreover, tax relinquishment, like general tax reduction, would fail to channel larger shares of the released revenues to the poorer States.

TAX CREDITS

A more effective way of increasing the chances that the States and localities would pick up the revenue released by the Federal Government would be to give a credit against Federal income taxes for certain State and local taxes paid. However, a credit would not automatically increase State-local revenues. The States and localities which already impose the taxes eligible for the credit would have to raise their rates. Since this could be done without raising total taxes paid by their citizens they might be encouraged to do so, but there would be strong opposition from the groups that would prefer to enjoy the tax reduction provided by the credit. The 17 States without individual income taxes would benefit from the full amount of the credit, provided they imposed such a tax and the credit applied to income taxes. Encouraging these States to enact income taxes would be desirable, but such a move might be regarded as Federal coercion and, in some States, would run up against constitutional barriers.

Tax credits, like the two previous alternatives, fail to redistribute

resources to the neediest States. At best, the credit simply diverts the same revenues from the Federal Government to the States where they originate.

TAX SHARING

Proposals have been advanced recently that the Federal Government share with the States all, or a portion of, the collections originating in each State from certain Federal taxes. Sharing of tax collections is a common arrangement at the State-local level, but not at the Federal-State level. All States share one or more taxes with their local governments. The usual basis for sharing, however, is not source of collection, but some measure of local need (such as population).

One tax that has been mentioned as a possibility for Federal-State sharing is the Federal tax on local telephone service. But the volume of telephone business is not distributed in a manner that corresponds with financial need. Other suggestions for tax sharing would also help the richer States more than the poorer ones. By the very nature of the plan, tax sharing cannot meet the criterion of equalizing resources of the State and local governments.

SPECIFIC GRANTS-IN-AID

Federal financial assistance to State and local governments is now given almost entirely in the form of grants to support specific types of government services. Total Federal grants already exceed $11 billion in this fiscal year. Further substantial increases have been recommended to the Congress and are likely to be enacted in the present session. If the administration's plans go through, Federal grants will amount to $13.6 billion in the fiscal year beginning July 1 of this year.

The main advantage of the specific grant approach grant approach is that the Federal Government regulates the conditions under which the funds are spent. It can choose to support activities in which there is a particularly strong national interest. It can set minimum standards. Through matching provisions and similar devices, it can ensure that the federally supported programs receive State support as well. Various formulas can be used to allocate funds to States where the need for the particular program is greatest or where fiscal capacity is least.

The new plan for assistance to primary and secondary school education proposed by the administration is a good example of the specific grant-in-aid approach. The Federal Government considers it essential to increase the educational opportunities of the children of low-income families. To this end, the administration proposes to distribute Federal funds to school districts (through the State government) on the basis of the number of schoolchildren in families with incomes below a certain specified level. The funds are to be used to meet the needs of educationally deprived children, on the basis of plans formulated by local school boards and approved by State boards of education. Special incentive grants are provided for school districts that increase their current expenditures by 5 percent or more. Public reports are required both from the school districts and from the State boards, so that the Commissioner of Education can evaluate the effectiveness of the program.

The support of particular activities through specific grants-in-aid will, and should, remain the basic method of providing assistance to the States and local governments. Only in this manner can the Federal Government assure itself that programs in which it has an interest are carried out by the States and local governments. At the same time, there are many State-local services of national importance that cannot be appropriately dealt with by specific grants. Unnecessary administrative burdens on the Federal Government would be avoided, and the varying preferences of States and localities could be allowed for more fully, if their ability to render these services were strengthened by the adoption of a more general grant system to supplement the specific grant programs.

A General Assistance Program for the States

The discussion so far suggests that the States and local governments will need assistance from the Federal Government over and above the assistance they will receive in specific grants. If a general assistance program were adopted, it would be desirable to devise some method to assure the States and local governments of a dependable source of funds that will grow with the needs of the growing population. Various methods have been proposed to achieve these objectives. For example, a certain percentage of Federal revenues, or of Federal income tax collections, or of the Federal individual income tax base might be set aside for this purpose. Each grows more rapidly than national income, and each would provide a satisfactory basis for calculating the amount to be allotted for State-local purposes. The difficult questions are (1) How should the funds be allocated among the States? and (2) What constraints should the Federal Government impose on the use of the funds?

METHOD OF ALLOCATION

Ideally, the amounts to be distributed to the States should be based on their need for public services and their fiscal capacity. Unfortunately, both need and capacity are very difficult to measure.

A State's need depends on its population and age distribution, population density, distribution of income, local costs, and other factors. A State's fiscal capacity also depends on a variety of factors, including population, per capita income, and the value of taxable property and sales. One formula that reflected all these factors would be difficult to construct and highly complex. However, population is probably the simplest and most appropriate measure of the relationship between need and capacity. On the one hand, population is a reasonably good indicator of general need for public services. On the other hand, a per capita allocation would make some allowances for varying capacity; since residents of high income States pay more Federal taxes per capita than do residents of low-income States, distribution on a per capita basis would redistribute resources from high- to low-income States.

Per capita distribution may not adequately reflect the more urgent need for fiscal assistance by the poorest States, but this deficiency could be recognized by reserving a part of the funds for distribution among

States with the lowest per capita income. It is not necessary to allocate more than a small proportion of the funds for this purpose to achieve a substantial redistributional effect. Even if as little as 10 percent of the total were divided among the poorest third of the States (say, in proportion to population weighted by the reciprocal of per capita personal come), the grant to the poorest State would be almost double the amount it would obtain on a straight per capita basis.

It might also be desirable to include a measure of tax effort among the factors determining the share of a particular State. A simple and effective way of allowing for effort would be to weight the per capita grants by the ratio of State to average tax effort in the country, where tax effort is defined as the ratio of State-local general revenues to personal income. Inclusion of such an effort factor would give the States an incentive to maintain and increase their own tax collections and allay the fears that States with lower-than-average tax rates were getting a free ride.

LIMITATIONS ON STATE USES OF THE FUNDS

I have already indicated that the most urgent national need is to allocate more of our resources to public programs which are primarily State and local responsibilities. Experience during the last several years indicates that, without central direction or coercion, State governments have actually used most of their scarce financial resources for those urgent needs. They have also allocated increasing amounts through grants-in-aid to local governments for education. (Between 1953 and 1963, 47 percent of the increased expenditures by States went to education—most of it through grants to local governments.) This evidence suggests that, if the States were to receive unencumbered funds from the Federal Government, they would spend them on urgently needed State-local services whether the particular services were stipulated in the legislation or not.

The Federal Government should satisfy itself that the funds would be shared with the local governments in an equitable manner, but this is also much less of a problem than most people might suppose. The extent to which the States delegate responsibilities to, and share revenues with, local governments varies greatly. All States give aid to local units and most give substantial amounts. (In the aggregate, intergovernmental transfers from State to local governments account for more than a third of State general expenditures and nearly 30 percent of local general revenues.) In view of the differences among States in forms of intergovernmental cooperation, it would be difficult to specify that some uniform percentage of the general grant be reserved for local use in all States. The individual States are in a better position to make the allocation in the manner suited to their particular circumstances. Moreover, legislative reapportionment will help assure that the needs of the communities will be recognized by the State legislatures. Several States are already making plans to use existing or new grant-in-aid programs for distribution to the localities of any unencumbered Federal funds that may become available in the future.

On the other hand, it can be argued that it is bad financial management for the Federal Government to give away its funds without

exercising a minimum amount of supervision to see that they are employed productively and in the national interest. One method of achieving this objective, and also of allowing flexibility for each State to meet the needs it considers most urgent, would be to require the Governors to file statements showing the plan for the use of the funds in detail. As guidance for the development of such plans, the Congress might indicate the general areas which it regarded as most urgent, including the need for making funds available for local government services. To be sure that the plan represented a broad spectrum of opinion in the State, the Governor might be directed to consult with local officials and representatives of citizens organizations before incorporating the plan in his budget. A detailed audited report on the actual use of the funds might also be required, as well as a certification by appropriate State and local officials that all applicable Federal laws, such as the Civil Rights Act, have been complied with in the State and local activities financed by these grants.

Conclusion

The States will be unable to meet their growing needs without substanial additional assistance from the Federal Government. Part of this additional assistance will come from specific grant programs which are already enacted or are now being considered by the Congress. But the States will need supplementary assistance in the form of general aid to help finance other State-local programs.

The States have important functions to perform in our system of government. They have been subject to criticism in the past, in part because of their inability to carry out these functions with the resources available to them. If we expect the States to play their role effectively, we should increase their ability to do a good job. The alternative is to shift their functions to the Federal Government, which is a solution that most people in the United States would rightfully oppose.

The type of general assistance program I have discussed would help revitalize State governments in this county. It would provide them with a growing source of revenue from taxes that are much more equitable than those that are now available to them. It would help eliminate the recurrent fiscal crises that have impaired their ability to function effectively. It would help them attract the caliber of people they need in executive, judicial, and legislative capacities. It would provide an additional margin for funds for strengthening their grant programs to local government units. And it would encourage them to solve their own problems rather than to vacate their responsibilities to the Federal Government.

In the light of the inadequacy of their finances, the States have made a remarkably good record in the postwar period. With reapportionment, they will do even better. Improvement of the finances of State governments, and through them the local governments, would strengthen our Federal system and, at the same time, increase the welfare of all our citizens.

Mr. Kappel. Thank you, Dr. Pechman. We have had two very thought-provoking and obviously well-considered subjects presented this afternoon.

I think in the interest of maximizing the time for discussion and questioning that I should now introduce all three gentlemen who are going to be our reactors.

I would like to introduce them and ask them to proceed with the program without my getting up here to repeat the job. I will do that in alphabetical order, which is the way in which they will appear.

George S. Moore received his bachelor of science degree at Yale; entered the banking business in the First National City Bank and, successively, has been assistant secretary, assistant vice president, vice president and executive vice president; and in 1959 and since, president of that bank.

Charles "Chuck" Percy received his A.B. from the University of Chicago; joined Bell & Howell as an assistant trainee in 1938, became manager of the coordinating department in 1941, corporate president in 1946, and chairman of the board in 1961. He was vice chairman of the National Republican Finance Committee in 1959; chaired the Platform and Resolutions Committee at the convention in 1960, and he can tell you about the election in 1964.

Nat Weinberg received his bachelor of arts degree from New York University before joining the United Automobile Workers. He served as a teacher in WPA Workers Education Project, and was assistant to the director of the research department, International Ladies Garment Workers. He was appointed director of the Research and Engineering Department of the UAW in 1947, and, since 1957 has been director of the special projects and economics analysis Department of that union.

I will subside now in favor of these three gentlemen.

COMMENTS BY GEORGE S. MOORE

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Mr. Moore. May I offer an incidental comment on Dr. Pechman's views? He refers to a prospective annual increase of $6 billion in Federal budget receipts. He indicates the $6 billion must be used up by increased Federal spending and additional assistance to State and local governments as well as by some Federal tax reduction. I should hope that part of increases in Federal revenue will be applied to narrowing and eliminating Federal budget deficits. I would admit this has to be done gradually, without fiscal drag on the whole economy. The drag effect comes from excessive taxation of productive enterprise.

It is true that businessmen, among other community leaders, are sensitive to increases in State and local taxes. Nevertheless, with Federal grants omitted, State-local revenues grew by 8.3 percent a year, compounded from 1953 to 1963. With the extra help of existing Federal grants and borrowing, State-local expenditures rose 8.8 percent a year, compounded over the decade. I would agree that there are some pressing needs. But I would also say they are being attended to. If our city fathers are going to run to Washington as an escape from local fiscal disciplines, the economic drag of high Federal income tax rates will be perpetuated. And Washington, in the end, may get forced into the business of taxing consumption.

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COMMENTS BY CHARLES H. PERCY

Mr. PERCY. Mr. Chairman and Mr. Secretary. Mr. Pechman has convincingly demonstrated that there exists a critical need among the States for general financial assistance. And as he states in the final sentence of his paper, "Improvement of the finances of State governments, and through them the local governments, would strengthen our Federal system and, at the same time, increase the welfare of all our citizens."

Few would argue with the desirability of these two goals—preserving the Federal system and advancing the general welfare. And most of us can agree with Mr. Pechman's broad method for achieving these ends: bolstering the fiscal posture of the States.

The arguments and objections arise when we confront his particular plan, which calls for the Federal Government to provide from its tax revenues general grants to the States to be spent at their discretion. Let us consider the validity of three principal objections.

1. Will the general assistance plan give the States fiscal integrity?

Some may argue that a direct, unrestricted Federal grant has no effect on the fiscal integrity of a State which remains dependent on the Federal Government for much of its revenue. However, this argument misunderstands the present fiscal condition of the States. The States lack monetary control, most are severely limited in their ability to borrow money, and the Federal income tax has seriously impaired their ability to expand their tax structure. Given such strict limiting factors, it is too much to expect the individual States to enjoy the economic freedom of the nation as a whole.

Under these conditions, the Federal general assistance grant proposed by Mr. Pechman would add substantially to the States' strength and independence in fiscal matters.

That the States need fiscal strengthening is shown clearly in the paper. The crucial problem shared by almost all States is that while expenditures are rising, revenues are lagging. Increased taxes are not the solution to this dilemma, for most State tax structures are relatively inelastic and inherently incapable of responding to the needs of an expanding economy.

Mr. Pechman estimates that the surplus of Federal revenues in the next 5 years will amount to roughly $30 billion. During the same period, he forecasts that the States will need an additional $30 billion beyond their current anticipated revenues.

Revenue and expenditure projections for the State of Illinois tend to confirm the general accuracy of Pechman's predictions of State needs. According to the Report of the Commission on Revenue of Illinois, Illinois expenditures will exceed anticipated revenues by a billion dollars in the period from 1965 to 1969. If funds were distributed under the Pechman plan according to population, Illinois would receive $1.2 billion for that same period.

What this would mean, of course, is that the State could maintain and perhaps even improve its present level of services without raising present taxes or instituting new ones.

This example is far from exhaustive, but it does indicate that the plan advanced by Mr. Pechman is of sufficient scope to prove of real value in aiding the States to gain fiscal integrity.

2. Can State fiscal autonomy help preserve the Federal system?

While inadequate revenue represents the most pressing of the States' needs, we should not close our eyes to the political condition which has generated the economic problem. Part of the States' fiscal quandary arises from a general lack of confidence in their ability to meet the needs of their citizens.

It was because of a breakdown of State political action that the Federal Government has been forced again and again to enter new fields of social service; and in order to do so, it has preempted State revenue sources by means of the Federal income and other taxes, leaving the States with an inadequate revenue base.

It would be easy enough for critics of the Pechman plan to say that unless the States are able to reform their politics, they have no business asking for unrestricted Federal revenues. But in order to reform themselves, in order to provide public services which they now cannot afford, the States need a more adequate supply of revenue.

Adequate State revenues could truly revitalize State government in this country. No longer would local political issues revolve around revenue problems to the point where other important issues are downgraded or ignored. No longer would State services be critically limited because of the lack of adequate revenue.

Unless we are willing to revitalize State government by restoring its independence, the Federal system itself is in danger. And certainly the current grant-in-aid programs tend to further curtail the independence of the States. The critical aspect of the Pechman plan is that the grants would be made with few strings attached as to how they would be spent.

This kind of assistance would encourage independence and responsibility among local authorities. The Netherlands, for instance, has used a similar system of grants with remarkable success in maintaining autonomous local action adequate to the needs of the Nation.

3. Will the welfare of the people be better served?

An important argument used to oppose the general assistance plan is that the welfare of the people will not be served if money is given to the States to spend as they see fit.

As I indicated above, many believe that State governments are incapable of spending money wisely. Pechman, however, has offered evidence in his paper to the contrary. He has shown how increased State expenditures have gone in large measure to meet health, education, and other pressing human needs.

He also has argued that reapportionment of State legislatures holds out the possibility of even more responsible State action in the future.

It has also been suggested that the welfare of the people will suffer because programs now supported by directed grants-in-aid will be abandoned in favor of the general grant program.

Mr. Pechman adequately answers this charge by showing that the expansion of Federal revenues would be used to pay for the general program, and that existing programs would not come into competition with it.

In my opinion, far from jeopardizing the welfare of the people, the general assistance plan will foster it; for surely the general welfare

is not unconnected with the success of State and local government. After all, local government exists because the Nation's founders believed that in a large country, central government which was too strong would result in tyranny and could destroy democratic government by weakening the ability of the people to govern themselves.

As our Nation and our Federal Government have grown, so too have these dangers; they have never been more real than now.

The crucial question before us is whether State and local government is worth saving. Some are quick to answer negatively, for they see only the failure of the States to respond to the pressing needs of our time. But this is a shortsighted approach. The answer which I have offered here is that we have it in order to encourage self-government, meeting needs close to the people, taking advantage of the principle of decentralization.

It is only when this kind of government is secured that we can be sure that the changing needs of the people will be consistently met over a long period of time. Since this is the ultimate purpose of local government, I believe that all available means should be adopted to realize it.

Mr. Pechman's solution is not only available, but it is sound. The fiscal position of our State governments is unique: They are equipped with inelastic tax structures, they are unable to meet needs through debt financing, they lack monetary control, and they have an inadequate tax base because of Federal preemption with the income tax.

A broad expansion of the present grant-in-aid programs will only tend to diminish the independence of the States. The general assistance program will strengthen the Federal system and in so doing increase the welfare of the Nation.

Thank you.

COMMENTS BY NAT WEINBERG *

Mr. WEINBERG. Mr. Kappel, ladies and gentlemen. As Mr. Cheadle knows—because he broke the news to me—I did not learn until Wednesday about noon that I was supposed to have a paper, and this one was prepared in such haste that I feel inclined to claim the usual Washington privilege of revising and extending my remarks.

As you will see, I have a different point of view from Mr. Percy on the paper I am supposed to discuss—Mr. Pechman's paper. I would judge from Mr. Percy's remarks that he is still running for Governor. I listened very carefully to what he had to say but I failed to find in his remarks any reason why the needs he so eloquently described could not be met and met better by specific grant-in-aid programs rather than by the general sort of "no strings attached" proposition that Mr. Pechman proposes.

I am in substantial agreement with many of the points made by Mr. Pechman, although I would have expressed some of them with greater emphasis. There can be no quarrel with his basic thesis that the fiscal burdens now placed on State and local governments must somehow be lightened. They must be lightened not merely because

* *Note.*—The views expressed are the author's and not necessarily those of the UAW.

many State and local governments are nearing the limits of their revenue resources, while demands on them continue to grow.

There are two other important reasons, one of which Mr. Pechman touched on very briefly, the other of which he implied but did not spell out fully.

The first reason why State and local burdens must be eased is because they are, in many cases, already far too heavy to be carried, and, in consequence, they are not being adequately carried.

I agree entirely with Mr. Pechman that there are glaring deficiencies in such areas of public responsibility as education, health, housing, and others. We have a vast backlog of needs requiring to be met—and it is entirely impossible for State and local governments to meet them unaided.

The second reason why State and local tax burdens should be eased is because they are highly regressive, and the tendency in recent years has been toward an increase in regressivity.

Mr. Pechman's table 2 indicates that 78 percent of the increase in State and local tax revenues between 1953 and 1963 came from taxes on property and consumption. Another 9 percent came from personal income taxes. Less than 3 percent of the increase in tax revenues came from corporation income taxes.

Analysis of his figures shows that, while State and local property tax revenues increased by 114 percent over the period, and taxes on consumption by 109 percent, corporation income tax revenues increased by only 86 percent. Revenues from personal income taxes rose by 208 percent, it is true; but this was in part, as Mr. Pechman points out, because such taxes "have been increased most at the lower income levels."

The increase in regressivity did not take place by accident, nor is there any economic law which ordains that it must be so. State and local tax burdens have become increasingly regressive because of the pressures of business interests on State and local governments to enact more regressive, rather than progressive, tax measures.

A substantial proportion of the States still have no income or corporate-profits taxes. Mr. Pechman referred to the fear of driving business away which restrains tax increases. Such fears are largely illusory. Business location decisions are made on the basis of much more important factors than tax levels or so-called business climates.

But there is no doubt whatever that the fears exist, and that they have been sedulously fostered by business groups not merely to restrain tax increases, but to influence the direction of tax increases toward greater regressivity.

Mr. Pechman suggests that any plan of assistance to State and local governments "should not reduce the progressivity of the total Federal, State and local tax system."

I would go further. What is urgently needed is not just protection of the present degree of progressivity but extension of it to counteract the opposite trend of past years. And this should be done not merely by shifting part of the burden to the Federal Government to be financed from more progressive revenue sources, but also by action at the Federal level which will impel the State and local governments to make their tax programs more progressive.

Turning now to the fiscal position and prospects of the Federal Government, I agree entirely with Mr. Pechman that as long as economic expansion continues, Federal revenues can be counted on to grow much more rapidly than the costs of present Federal programs. And I say a fervent "amen" to this contention that if the resulting "dividend" is used for debt retirement, the result can only be to choke off the very expansion by which the dividend is produced. But I would take a much stronger position than he does on the issue of increased public spending versus tax reduction.

I do not think these alternative methods of eliminating fiscal drag can be given anything approaching equal weight. I have never been able to accept the point of view that a hundred dollars spent for private entertainment in a night club does just as much, or more, for the economy and the society as a hundred dollars spent by Government on education.

As long as we have the glaring deficiencies which exist today in practically every area of public responsibility except national defense, it seems to me imperative that every additional revenue dollar which becomes available should be used to help make up those deficiencies, with the one exception of tax relief needed by those at the bottom of the income structure, who are now being burdened unjustifiably.

How unreasonable that burden is can perhaps be appreciated from the fact that the Federal income tax is payable by families with incomes so low that they are entitled to assistance under the Food Stamp program. In fact, in determining eligibility for food stamps, administrators of the program in many States are instructed to deduct from gross family income any income taxes paid.

But the need to correct anomalies such as this should not be made the excuse for tax cut programs for the benefit of those who already have more than they can readily spend. It was a sad irony, for example, that last year's tax cut, the bulk of which went to corporations and to individuals well above the poverty level, diverted more from Federal revenues than the $11 million the Council of Economic Advisers had estimated would be required to bring every poor family in the country out of poverty.

Tax cuts at the top of the income structure are economically unsound as well as socially unacceptable since, as Mr. Pechman points out, the rate of private savings is already tending to exceed the rate of private investment. Tax cuts for the wealthy serve only to widen that gap.

In this connection, I would refer also to the analysis recently made by Mr. Pechman's colleague, Bert Hickman, of the step-up in the productivity of capital, which results in a faster growth of potential output per dollar of investment. This adds to the necessity for increases in public spending and for tax cuts to be concentrated at the bottom of the income structure in order to maintain a correspondingly faster rate of increase in demand.

As Mr. Pechman recognizes, increased spending is also necessary to meet our long-neglected public needs. Far from overspending, as some would allege, our Federal Government has been grossly underspending—and one result, in addition to the failure to meet our public

needs, has been the rising tide of unemployment which even after 4 years of recovery remains at an intolerably high level.

Another consequence of public penny pinching at the Federal level has been the loading of unconscionable burdens of responsibility onto the State and local governments—burdens so heavy that they are unable to carry them and in fact have not been carrying them. Here again, the inspiration for such an irrational procedure has come from the business community, which by and large has opposed practically every move toward expansion of the Federal area of responsibility which would have helped to ease the burdens of State and local governments.

The narrow interest of business has been clear—to restrict Federal spending which is financed through more or less progressive taxation, and to shift burdens to State and local governments whose revenue sources are both restricted and regressive and whose legislatures are more susceptible to manipulation than the Congress.

The serving of that narrow interest may have saved business some immediate tax dollars, but it helped to bring on years of economic stagnation and recurring recession that have cost business dearly in the loss of sales dollars and have cost the Nation even more dearly through high unemployment and lost production.

The answer, however, does not lie entirely in a greater transfer of funds from the Federal Treasury to those of the States; and it certainly does not lie in parceling out Federal revenues to the States with no strings attached and with no assurance that they will be used to meet public needs.

We should not despair of getting the Federal Government to meet its responsibilities or seek to appease forces who oppose meeting them; rather, we should intensify our efforts to assure that it does meet them.

There are major areas of Federal responsibility still waiting to be met. In many of them, acceptance of its responsibility by the Federal Government would automatically tend to ease the burdens which now lie so heavily on State and local governments.

The most outstanding example is the war on poverty. A fully effective Federal attack on poverty—which faces up directly to the fact that people live in poverty because their incomes and assets are too small to provide a decent living standard—would ease State and local burdens both directly and indirectly.

An effective attack on poverty must do three things in addition to those being done under the present poverty program.

It must directly provide adequate incomes for those who are poor because they are too old, too young, too ill, or too encumbered with family responsibilities to earn for themselves.

It must provide jobs—and in the meantime adequate unemployment compensation—for those who are able to work but cannot find work.

It must assure decent wages for those who are working.

This means that we need a vastly improved program of transfer payments, including both social security and general public assistance, with adequate benefit levels nationwide and with coverage sufficiently broad that no needy person will be overlooked simply because

he does not fit into any convenient category. Such a program can be effective only at the Federal level.

We need a national full-employment policy, which is entirely a Federal responsibility, and involves, among other things, a substantial increase in Federal spending.

We need minimum wage legislation which will also be adequate both as to coverage and benefits. The law should protect all workers and should protect them at a level which would not mean—as the present $1.25 minimum does—that a worker may be fully employed all year and still end the year with earnings that are insufficient to maintain him and his family above the poverty lines.

As I have said, an effective attack on poverty using these weapons would ease the burden on State and local governments both directly and indirectly.

It would ease them directly by taking over full responsibility for welfare and a much larger share of responsibility in such areas as housing, urban redevelopment, and public works where increased Federal spending is a necessary ingredient of full-employment policy.

It would ease them indirectly both through the improved tax base which would result from elimination of poverty, and through reduction of the cost of such services as police and fire protection, which are always at their highest in slums and near-slum neighborhoods.

This does not mean that Federal grants-in-aid to the States should not be both increased and extended to additional programs. They should be—and particularly if those of you who disagree with me about direct Federal spending continue to have more influence in Washington than those who agree with me, Federal grants-in-aid should be greatly increased. We cannot continue to leave large areas of public need unmet at both levels.

Where Mr. Pechman and I completely part company, however, is on the proposition that such grants should be given with "no strings attached." Mr. Pechman's recital of the advantages of grants for specific purposes is most convincing. I note his own belief that such specific grants "will, and should, remain the basic method of providing assistance to the state and local governments."

I would go one step further and say that, as far as assistance in the form of grants is concerned, it should be the only method—at least for the foreseeable future.

Through specific grants, the Federal Government—and the taxpayers—can be sure that the funds granted are used to meet public needs, and not to provide tax relief to favored groups. To provide even greater assurance against the latter, it would be appropriate in certain programs to put heavy emphasis on "tax effort" as a factor in determining allocation of funds.

I think, however, that the ratio of State and local tax revenues to discretionary income would be a fairer measure of tax effort than the ratio to total personal income.

I would repeat also my earlier suggestion that Federal action should be taken to impel the States toward greater progressivity in their tax structures. This might be accomplished if, in measuring tax effort, substantially more credit is given for revenues from corporate and personal income taxes than from sales and property taxes.

Only through specific grants, moreover, can we assure that programs are directed toward the most urgent needs (as contrasted, at times, with those which might have greater political charms), that local governments get their fair share, and that adequate standards are maintained.

For example, in some States we can be assured that programs will be administered without racial discrimination only if the necessary conditions for Federal support are very carefully and specifically spelled out to include such requirements. The same is true of maintenance of proper wage standards.

Mr. Pechman says that "there are many State-local services of national importance that cannot be dealt with appropriately by specific grants," but he gives us no indication what the nature of such programs might be. He does indicate that a supplemental system of untied grants would permit "the varying preferences of States and localities" to be allowed for more fully. But if those varying preferences do not accord with national priorities, why should they be supported by Federal funds?

It is probable that State and local government needs will continue to grow faster than their fiscal resources. We should not close our minds to the possibility that some sound means may be developed to assist them other than through grant-in-aid programs.

But the Federal Government is not yet financing adequately its direct civilian responsibilities; and we are still far from exhausting, in magnitude and in type, the programs that need and deserve Federal assistance in the form of specific grants-in-aid.

After—and only after—both direct Federal and grant-in-aid programs have been fully and adequately financed, I would be willing to consider other forms of aid to State and local governments. Even then, I would want to make certain that discretion in the use of Federal funds was confined within a range of programs of high and approximately equal urgency from the standpoint of the national interest and that the programs conformed to specified minimum standards, including nondiscrimination.

In return for the discretion allowed in the use of such funds, I would insist, as a condition of the grants, that the State and local governments meet rigorous standards of tax effort and tax equity. But that is for the future, and, at the present pace of our progress toward meeting our highest priority public needs, it appears to be for the long-run future.

Meanwhile, if we are to make the most efficient and effective use of all tax revenues, we must have greater coordination of Federal, State, and local programs—not less. Let the Federal Government face up to its responsibilities in such purely Federal fields as a national war on poverty, including the achievement of full employment. Let it also provide specific grants-in-aid in sufficient amounts to enable the State and local governments to carry their responsibilities.

But let us not embark on a program of general handouts which, at best, could only increase the multiplicity of uncoordinated and possibly conflicting programs, and, at worst, could mean the diversion of tax dollars to purposes which might serve no public interest.

Mr. KAPPEL. We are going to have these questions now and I assure you you will be through at 4:30. I am going to ask the first question

of Mr. Weinberg. What criterion can be used in saying which responsibilities are Federal and which are local? I think you went quite a way in that.

Mr. WEINBERG. That is a very good question and it brings me to a subject for which I did not have space in my paper but which I think is pertinent. We have no mechanism in this country at the present time for reaching a national democratic consensus as to our needs and our priorities.

Other democratic countries—in Western Europe, for example—have adopted democratic economic planning mechanisms. Through such mechanisms, resources and needs can be evaluated and a consensus developed as to priorities in the application of resources to immediate needs.

Through such a mechanism, we could develop an answer to the question we have been discussing today with respect to the division of the fiscal dividend between the private and the public sectors. In the public sector we could determine the order of priorities. Lord knows we have enough to keep us busy in this country into the indefinite future in trying to meet our needs with the resources available. We could develop an order of priorities that, being democratically determined, would be accepted by all important groups in the country, and we could get to work on correcting the shameful situation we have in our schooling, our housing, our urban renewal programs, our backlogs in health facilities, in resource conservation development, and so on.

Through a planning mechanism we could decide which were the best political mechanisms for meeting our needs, whether through State or Federal action or a combination of both. We could also meet another problem which would arise under Mr. Pechman's proposal; namely, the problem of meeting needs on the basis of the actual geographical entities in which the needs occur and not on the basis of the arbitrary political borders that we have which sometimes do not fit economic realities at all.

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Mr. KAPPEL. Mr. Pechman, you indicated in your remarks that it would not be desirable to reduce the progressivity of the Federal income tax structure. Earlier we heard Professor McCracken argue that exactly what is needed is less progressivity, and it would appear you have different views of what would be called fiscal drag.

Can you say how you and Professor McCracken arrived at different policy prescriptions as best you can see the situation?

Mr. PECHMAN. I don't think Professor McCracken and I disagree at all. He is talking about the progressivity of the nominal tax rates and I would agree that the progressivity of these rates is very high. When you take into account that the fact we have a large number of exclusions and deductions in the tax law, the degree of progressivity in the income tax is really moderate.

As a matter of fact, the average effective rate does not go above 30 percent in the very top brackets.

The problem as I see it, and as he sees it, is to be sure that the revenues that are generated by a progressive tax system, even a

moderately progressive tax system, do not prevent the economy from growing and in this respect we agree.

Mr. WEINBERG. May I pitch in on that one? Of course the way to prevent revenues generated by any tax system from stifling growth in the economy is to use them. On the question of a progressive tax system, I said something very briefly in my statement that I think is of considerable importance and I think some attention ought to be paid to it.

Mr. Pechman referred to the tendency in our economy toward oversaving. I think this is documented in a new way by the recent study of the Brookings Institution written by Bert Hickman in which he points to the rising productivity of capital as indicating the necessity for greater consumer spending and for greater public spending in order to take up the gap that will be left by the fact that you will need less investment in plant and equipment as time goes on to generate any given increase in gross national product.

That argues not for a decrease in progressivity of the tax structure but for an increase in the progressivity of the tax structure including the closing of some of the loopholes that detract from its theoretical progressivity.

Mr. KAPPEL. I have a question for Mr. Percy. Today Illinois sends more money to Washington than it gets back in grants-in-aid, and so forth. You asked for more Federal aid for Illinois. Wouldn't this drastically decrease the imbalance of the amounts the citizens of Illinois send to Washington and the amounts they get back?

Mr. PERCY. It depends very much on the formula that is developed. There is no question but that Illinois and most industrial States do send to Washington more than they get back. I don't think we object to that if it improves the quality of education in five or six Southern States. After all, we are a nation of States and as long as some States are less well off, the other States will suffer.

For that purpose I think we have had to take into account the fact that there are disparities in economic abilities of the States. Many of the States in the South have been given a very high proportion of cost to education and still can't provide enough support. They are getting better with their industrial programs, but the formula that we would use on the grant-back would not take into account those factors but would be more on the basis of the need of the State as it exists and more in proportion to population and its contribution, I hope, to national income.

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Mr. KAPPEL. Dr. Pechman, you made the point in your discussion that State and local tax rates are unlikely to rise enough to finance projected spending because of strong voter resistance.

Despite obvious needs for further spending, if the voters resist higher tax rates, it would seem that the needs are not at all obvious and that increasing Federal grants-in-aid to States and local governments would merely succeed in circumventing voter wishes. Is it possible that what is needed is a sharp reduction in Federal grants-in-aid rather than an increase?

Mr. PECHMAN. The short answer is No, but I want to elaborate.

It is true that there is voter resistance, but this occurs because it is very difficult for States and local governments to get out of line with the tax levels in neighboring communities.

If, for example, the State of Maryland enacted very high income taxes, some people might move out of Maryland. Similarly, if it enacted higher corporate taxes, businesses might not come into the State.

In a national system like ours, it is very difficult for some States to make more use of the tax sources which grow with the growth of the national economy. That is why the Federal Government, which can levy such taxes, should allocate some of them to the States.

I do not believe that there is voter apathy at the State-local level. On the contrary, they have made a remarkable effort. They have increased property and sales taxes and they need more help.

Mr. WEINBERG. A large part of the local opposition comes from the regressive nature of the taxes involved at the local level—school bond issues have been defeated in many areas because existing sources of funds—essentially profit taxes—are so burdensome on lower income groups that they vote against the bonds.

This does not mean they do not recognize the need but they recognize that they are already shouldering more than their fair share of the cost of meeting that need.

In Michigan we have a 4 percent sales tax that covers food and drugs as well as other goods, and we have no corporate income tax and no personal income tax. We have property taxes that have reached the outermost limits.

This is the kind of situation that makes for the defeat of proposals at the State and local levels to meet the needs.

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MONEY FOR THE STATES*

BY JOSEPH A. PECHMAN

First broached in 1964 by Walter W. Heller, the idea that the Federal Government should share some of its revenues with the 50 States and over 90,000 local governments has an unusual degree of support from moderates in both political parties. The opposition comes mainly from conservatives who always prefer tax reduction to better public services, and from liberals and bureaucrats who believe that major decisions about public services should be made in Washington.

Revenue sharing is intended 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. Most Federal revenues come from income taxes that rise at a faster rate than income as income grows. By contrast, State-local revenues barely increase in proportion to income. One reason is that the Federal Government has virtually preempted the fruitful income tax. Ninety percent of the taxes that are levied on incomes of individuals and businesses in this country goes to the Federal Government, though 33 of the 50 States tax incomes. States are generally reluctant to increase taxes on incomes, for fear of losing business to other States.

State-local needs have outstripped the potentialities of their revenue system at constant tax rates, so that the rates have been pushed steadily upward throughout the postwar period and many new taxes have been added. But essential public services are starved by Governors, mayors, and legislators who naturally try to avoid the politically distasteful—and sometimes politically suicidal—choice of increasing taxes. Furthermore, State-local taxes are on balance regressive; they impose unnecessarily harsh burdens on low-income recipients.

Stripped to essentials, the revenue-sharing plan would operate as follows:

A portion of Federal revenues would be automatically set aside each year in a special trust fund on the basis of a predetermined formula.

Disbursements from the fund would be made primarily on a per capita basis, a method that automatically helps the poorer States relatively more than the richer States.

The funds would be turned over to the States, with the understanding that a major share would go to the local governments.

Constraints on the use of the funds would be much less detailed than those applying to conditional grants. However, the funds would not be available for highway construction, since there is a special Federal trust fund with its own earmarked revenue sources for this purpose.

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An audit of the actual use of the funds would be required, as well as certification by the appropriate State and local officials that all applicable Federal laws, such as the Civil Rights Act, have been complied with in the activities financed by the grants.

The per capita method of distributing the grants was chosen because it is the best available index of State fiscal capacity and need. It allocates more money to the populous States; at the same time, it automatically distributes relatively more to a poor State than to a rich State. For example, a $25 per capita distribution would amount to 10 percent of the budget of a State that can afford to spend $250 per capita and only 5 percent of the budget of a State that can afford to spend $500 per capita. More equalization could easily be provided if desired; for example, a small part of the fund, say, 10 percent, could be allocated to the poorest third of the States. Tax effort could also be given some weight in the formula, thereby encouraging States to maintain or increase tax collections out of their own sources, and penalizing those which might yield to the temptation of reducing State taxes.

On the other hand, it would be totally inappropriate to allocate the funds in proportion to the amounts collected from each State. This would give disproportionately larger shares to the wealthiest States, and would widen rather than narrow differentials in State fiscal capacities.

The same criticism holds for the various types of Federal income tax credits for State income taxes, which are often proposed as a substitute for revenue sharing. The tax credit is a method to coerce States to adopt income taxes (and is needed for that reason), but it is not a good device for achieving the equalizing objectives of revenue sharing. So long as State shares of Federal money depend on income, wealthy States will do better than the poorer ones.

Several methods can be used to calculate the amounts to be set aside annually for revenue sharing. The two most important criteria are that (*a*) the amounts should grow more than in proportion to the growth of the economy, and (*b*) the changes that might be required with the passage of time should be held to a minimum. The first criterion would be satisfied by any one of a number of growing bases—for example, total Federal revenues, total income tax revenues, and the individual income tax base. The second would be satisfied best by the individual income tax base (i.e., taxable income) which is changed only rarely. Actual income tax receipts could also be used, provided Congress is prepared to change the revenue-sharing formula when tax rates change. On balance, the income tax base is preferable.

Another $6 Billion

At this year's expected income levels, that base is in the neighborhood of $300 billion and the allocation would amount to $3 billion for every percentage point of the base. If the Vietnam war were to end soon, the Nation could easily afford to allocate two points of the income tax, or $6 billion, for revenue sharing, as an addition to the $15 billion a year that the Federal Government already sends the States in grants-in-aid. This extra $6 billion would be enough to finance general grants

average $30 per capita. At this rate, California would receive about $580 million, New York $560 million, Massachusetts $160 million, Wisconsin $125 million, Maryland $110 million, Mississippi $65 million, and so on. Equally important as the amounts, the grants would automatically grow with the tax base—in a full-employment economy, they would double every 9 years.

The plan is often criticized because the States and local governments might be in trouble if the revenue-sharing funds declined during a recession. But it turns out that this is not a matter of great concern. The tax base has declined only twice since the end of World War II—by 4 percent in 1949 and by less than one-tenth of 1 percent in 1958. These are within the range of fluctuations that State and local governments are accustomed to in some of their own tax sources. But even if a deep recession occurred, Congress could easily add to the statutory amounts to prevent State-local distress. Few antirecession measures would satisfy both the efficiency and stabilization objectives as well as revenue sharing. Rather than reducing the Federal Government's flexibility to combat recessions, as some allege, the plan would provide another useful outlet for Federal funds in these circumstances.

Some people have embraced the revenue-sharing plan as a method of undercutting the present Federal conditional grant system: a few would even replace the present grants by unconditional or general-purpose grants. But the two types of grants have very different functions and these cannot be satisfied if the Federal system were limited to one or the other.

Conditional grants—for example, for urban renewal and public assistance—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.

General purpose or block grants—for example, for health, education, and welfare as a block—are justified on different grounds. In the first place, all States do not have equal capacity to pay for local services. Even though the revenue effort of the poorer States is average, they are unable to match the revenue-raising ability of the richest States. Second, Federal use of the best taxes (i.e., on income) leaves a substantial gap between State-local need and State-local fiscal capacity. Moreover, no State can push its rates much higher than the rates in neighboring States for fear of placing its citizens and business enterprises at a disadvantage. This justifies some Federal assistance even for purely State-local activities, with the poorer States needing relatively more help because of their low fiscal capacities.

For these reasons, the general-purpose grants are intended to supplement the conditional grants, not to replace them. Considering the large unmet needs throughout the country for public programs with large spillover effects (education, housing, et cetera), adoption of revenue sharing should not be the occasion for reducing conditional

grants. It is a well-known axiom of logic that two objectives cannot be satisfied by using only one instrument.

The most serious criticisms of revenue sharing come from those who have lost faith in the State governments. On the whole the States have been doing a good job, although there are exceptions. Without central direction or coercion, they have actually used most of their scarce resources for urgently needed State and local programs. Between 1955 and 1965, general expenditures of State governments rose steeply by $23 billion, to around $40 billion. Of this increase, about 60 percent went for education, health, welfare and housing—more than 40 percent went to education—most of it through grants to local governments. This evidence suggests that, if the States were to receive unencumbered funds from the Federal Government, they would spend them on urgently needed services whether the particular services were stipulated in the legislation or not. To be specific, if the Federal Government allocated $6 billion for revenue sharing, there is little doubt that about $3 billion of this money would be spent on teachers' salaries, school buildings, and other educational needs.

The Federal Government would, of course, expect the States to pass the funds through to their local governments in an equitable manner, but this is much less of a problem than most people might suppose. 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 17 percent of State-local revenues. Thus, even without any specific requirements, the local governments would receive at least a third of any general funds the States might receive from the Federal Government.

Safeguarding Local Units

But there is no reason why the Federal Government should not write a "pass-through" formula into the plan to be sure that the States will turn over to their local units an even larger share of the revenue-sharing receipts than they might otherwise allocate. This can be done in two ways:

1. The revenue-sharing legislation might provide that all States must pass along a certain percentage of the grants to their local governments. In view of recent trends, the minimum should be at least 40 percent and might even be as high as 50 percent. This would prevent any State from short-changing its local governments (although it might be difficult to detect offsetting reductions in existing grants if the State legislature was of a mind to do so). The disadvantage of a fixed percentage is that the extent to which the States delegate responsibilities to, and share revenues with, local governments varies greatly. In some States, the appropriate percentage may well exceed the 50-percent mark, and in others it may be below it. The danger is that any minimum percentage is likely to become a maximum, so that stipulating the percentage may do more harm than good in some States.

2. A more flexible method of handling this problem is to require the Governors to prepare detailed plans for the use of the funds. As guidance for the development of these plans, the Congress might indicate the general areas which it regarded as most urgent, including the need for making funds available to local governments. To be sure that the plan represented a broad spectrum of opinion in the State, the Governor would be directed to consult with local officials and representatives of local citizens' associations before incorporating the plan in his budget. The development of such plans would provide the occasion for a complete review and possibly a revamping of State-local relations throughout the country.

The second method provides more flexibility and greater opportunity for initiative and innovation in State-local relations. However, if Congress believes this decision cannot be left to the States, the fixed percentage method is certainly consistent with the spirit and intent of the revenue-sharing plan. In either case, the net additional funds that would be funneled to local governments would be greatly increased.

The States are an essential feature of our federal system of government. A local government is efficient to do some things, but not others. In taxation, for example, large local tax rate differentials encourage people to move to other communities or to purchase elsewhere to avoid taxation. As for expenditures, not a single large city has the financial capacity to support higher education, health facilities and other urgent expenditures, as well as to pay for the heavy welfare costs. With the growth in population, the States are rapidly becoming metropolitan governments in the true sense of the word—Maryland and Connecticut, for example. For reasons of efficiency, the State governments cannot be permitted to wither away.

There is little doubt that the quality of State governments varies greatly. But this is changing quickly in many parts of the country, as the effects of reapportionment are felt. Furthermore, there is no point in denying urgent fiscal aid to the "good" States merely because there are some "bad" States ("good" or "bad" in their attitude toward public services). As the last election demonstrated, States change complexion rapidly—Maryland is an example of a State that went from bad to good last November, and California is an example of one that went from good to bad. It should also be added that the State governments do not have a monopoly on incompetence—many of the Federal bureaucracies administering grants are something less than models of efficiency.

In brief, revenue sharing will provide the States with a growing source of income from taxes that are much more equitable than those now available to them. Much of this money will go to local governments with or without legislative safeguards. There is no better way to help finance the urgently needed public services, and at the same time, to strengthen our federal system of government.

FINANCING THE FUTURE OF FEDERALISM: THE CASE FOR REVENUE SHARING*

BY THE TASK FORCE OF THE REPUBLICAN NATIONAL COMMITTEE**

A major element of American history has been the nature of the federal partnership between the national government on the one hand, and the States which form it on the other. Today, as for the past third-century, the problem of American federalism has been one of ever-increasing centralization of power and responsibility at the national level, a growing State dependence on largesse from Washington, and a weakening of the abilities of States to meet their responsibilities.

Many factors have combined to bring this situation about. But none of these has more impact than the imbalance in revenue sources available to the several levels of government. As a practical matter, the National Government has preempted the graduated income tax as a major revenue source.

For the most part, State and local governments have been left to rely on three major sources for the bulk of the revenues they need to operate. These three sources—property taxes, sales taxes, and income taxes of flat or only mildly progressive rates—have tended only slightly to keep pace with inflated prices, and the mushrooming demands for governmental services. In an era of economic growth conditions, revenue and credit sources available to State and local governments have not increased at rates at all commensurate with demands and prices.

By comparison, the highly progressive income tax on which our National Govenrment relies for the bulk of its revenue is a powerful source of revenue in a growing economy. Without tax increases and despite tax reductions, the amount of funds available to the National Government has grown steadily year by year. Currently, the built-in increase in revenue amounts to some $6 billion annually.

Thus, the financial plight of governments in America today is one of fiscal abundance at the national level, but fiscal poverty at State and local levels. This has had an inevitable impact on governmental and political leaders. At the State and local level, the pinch caused by insufficient funds has created a reluctance to embark upon new programs demanded by an increasing metropolitan population. At the national

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The present document owes a considerable debt to a research paper, *Fiscal Poverty Amid Federal Plenty*, prepared by Dr. James M. Buchanan of the University of Virginia at the request of Mr. Winthrop Rockefeller, a member of the Task Force. Copies of Dr. Buchanan's paper are available upon request from the Research Division, Republican National Committee, 1625 I Street, N.W., Washington, D.C. 20006.

**Task Force on the Functions of Federal, State, and Local Governments of the Republican National Committee, Washington, D.C., March 1966.

level, the predicament is reversed. The ready availability of funds leads to approval of new programs and commitments without sufficient examination of the desirability of national governmental action.

Four paths of action are open to the national government to utilize the ever-increasing flood of revenues produced by the national income taxes: (1) Expansion of direct spending; (2) Tax reduction; (3) Retirement of the national debt; and (4) Expansion of indirect spending via programs of grants-in-aid. The last of these has increasingly been utilized to absorb the new revenues.

THE GROWTH OF GRANTS-IN-AID

In 1934, 18 grant-in-aid programs existed to disburse National Government funds for specific purposes to State and local governments. Thirty years later, that number had risen to 68 programs to State and local governments, plus an additional 60 programs for disbursement of funds to individuals and institutions. Adding in additional programs which have been authorized since 1964, there are today some 140 grant-in-aid programs of the National Government.

The growth in the amount of money involved is staggering. Grants in 1934 totaled $126 million. By 1964, this had risen to $10,060 million—80 times the 1934 total. Expenditures per program increased from $7 million in 1934 to $148 million in 1964.

The most conservative of projections to 1984 is alarming. Based on increases in the 1934–64 period, the total of grants-in-aid to State and local government projects to $52 billion, an increase of 556 percent over 1964.

Typical of the grant approach has been a steady increase in controls and restrictions tied to the money. This has produced at one end an increase in the national bureaucracy, and at the other a further demeaning of State and local governments and their officials.

The Republican Party has always advocated the strengthening of our State and local governments. But clearly, these governments will be able to meet less and less of their responsibilities if additional sources of revenues are not found. Reliance on specific grant-in-aid programs controlled from Washington is not the answer. At the worst, the States will continue to sink into a morass of financial inadequacy and eventual bankruptcy. At best, they will become mere administrative appendage of the National Government.

SHARED REVENUES: A PROPOSAL

The solution to the problem of States slowly strangling for lack of funds amid the fiscal abundance of the National Government must be one which emphasizes the independence of the States and not a system which ties them further to Washington.

We therefore propose a system to share the personal and corporate income taxes collected by the National Government with the States. Under this plan, one-half of each State's share would be computed on the basis of returning income tax collections to the State in which they originated. The other half of each State's share would be computed in a way which will provide some measure of fiscal equalization.

We recognize that some States are wealthy, while others are in serious need. Equalization cannot altogether alleviate fiscal inequities among the States but no plan of revenue sharing is feasible unless some degree of equalization is included. The equalizing formula should be simple and could be based upon population and per capita income levels.

Equalization grants should be made only to the States which themselves contribute a fair proportion of their per capita incomes to the costs of their own State and local services. This fair proportion should be defined in the statute. Grants to any State should be reduced proportionately if the State and its local units do not apply an adequate amount of State and local tax revenue.

We also believe that the provisions of title VI of the Civil Rights Act of 1964 prohibiting racial discrimination in federally financed programs should apply to this revenue-sharing system.

In accordance with this two-part plan, we urge that 2 percent of personal and corporate income tax collections be returned to the States in the first year of implementation. (If this program were to take effect in fiscal year 1967, the total amount involved would total less than $2 billion.)

Thereafter, the percentage of collections returned should increase 2 percentage points every 2 years. If fiscal year 1967 can be the first year of implementation at a 2-percent rate, the proportion shared would rise to 4 percent in fiscal 1969, 6 percent in fiscal year 1971, 8 percent in fiscal year 1973, and 10 percent in fiscal year 1975.

At current tax rates, income tax collections over the course of the next 10 years are expected to increase some $50 billion. This proposal for shared revenue would earmark $11.5 billion of the $50 billion for the States. The remainder, $38.5 billion, is clearly sufficient to allow for some reduction in the national debt, periodic tax reductions, reasonable expansions of programs of direct National Government spending, and some degree of specific grant in aid programs.

Once instituted, however, it is imperative that a sharing of revenues continue. Future budgets of the National Government should provide for the proportion of revenues to be redistributed, regardless of whether or not budgetary surpluses exist. To place the States in a position where they would not know from year to year whether they will receive their share of tax collections would place them in an agonizing plight, and create a crisis in State and local finance far more chaotic than anything we have seen to date.

A System of Functional Grants

In addition to sharing revenues with the States, we urge the institution of a system of *functional grants* to the States with a minimum of supervisory controls. Thus, the National Government would make grants to the States in broad, functional areas (such as mental health, education, water pollution control, highways, etc.), without pin-pointing the precise program through which these funds would be spent. This would have the virtue of providing financial assistance to the States to solve problems of national importance while allowing the States to use the funds to solve these problems in their own way.

Obviously, a condition must be met that the State governments not decrease their preexisting expenditures in the problem area.

Decreasing Centralized Control

These proposals have two objectives:

First, to provide for the States and their localities a steady source of funds with which to meet public demands for governmental services and one which will grow more or less proportionately to increases in the gross national product.

Second, to free the States and local governments from the maze of regulations, paperwork, redtape, and restrictions which hamper them in their efforts to serve their citizens.

One of the strengths of the American system has been diversity. Different States try different approaches to problems, and all benefit by the experiment. Likewise, different areas have different problems which must be met in different ways.

If this strength of diversity is to be maintained and increased, the controls and restrictions placed by the National Government on the States' utilization of shared revenues and functional grants must be at a minimum. Preauditing should be avoided; so should schemes which require advance approval of State and local plans or programs from Washington. The States must be free to plan and act with a minimum of pressures from the National Government, regardless of whether they arise from those who act in the name of fiscal responsibility or those who seek the expansion of the influence of the Central Government. Procedural qualifications should, however, include such obvious basics as prohibition on the use of funds to deprive citizens of constitutional rights.

Comparison With Other Proposals

The idea of revenue sharing outlined here is not a novel one. Numerous plans to share in some manner the revenues of the National Government with State and local governments have been advanced by many people, including Republican Members of Congress and Republican Governors. In particular, the Heller-Pechman scheme has received much public attention. That plan recommended that 1 percent of the *base* for the national income tax be returned to the States through bloc grants, using population only as a mild factor of equalization. While this plan would return more money initially, it lacks provision for increasing the amount over a period of time. Such a provision, together with stronger equalization factors, is essential in any plan to redistribute tax revenues.

Specific Grant-in-Aid Programs

The specific grant in aid is an approach with limited utility. In some areas, such as the development of the Interstate Highway System, it has been a marvelous tool in a National-State partnership. But in many other problem areas, it has created a maze of bureaucracy and confusion which has produced almost as many problems as the program was designed to solve.

Too often, States have programed activities for which national grants in aid are available, without due regard to whether such programs are as essential as some others for which national grant money is not available but for which there is a greater need within the State. Thus grant programs have frequently had the effect of skewing State plans and budgets toward problem areas which are considered important in Washington, but not necessarily within the State. Moreover, Federal matching-fund requirements have frequently dictated types of approaches to problem areas and have hogtied State budgeting.

Assuring State Participation in Policy Formation

All grants, whether functional or specific, should be subject to two important conditions which have been frequently recommended by studies on intergovernmental relations.

First, no new grant programs should be passed until the opinions of the governors of the States about the desirability of the proposed grant have been presented to Congress. There may be a few occasions in which a grant for a function of urgent national importance should be carried through even though the State Governors are not in agreement. But it is very wrong to do what we are doing—building up an entire system of national fiscal controls on State and local governments without adequate consultation with State and local authorities.

Second, there also should be provision for careful review of grants by Congress and the administration every 5 years. A number of grants which were started as "stimulating grants" have been on the statute books, in some cases for almost half a century, without careful consideration of the desirability of the National Government's remaining in the field concerned.

* * *

The proposals we have made here—for a broadbased sharing of national revenues with the States, for a system of functional grants, and for a reformulation of the use of specific grants—all are designed to foster a rebirth in the ability of the States to handle their own problems. The Republican Party has always had faith in State and local government as the best tool to solve many of our pressing governmental problems.

But expressions merely of faith are no longer sufficient. We believe that the States must help themselves, that they must develop a greater will to meet contemporary problems. The proposals we have advanced will give them the tools to do the job. But it is up to our States—those who united to form our Union and those who later joined them—to bring about their own maturity and to achieve their own destiny. In so doing, our Nation will have attained the peak of its own high purpose.

FEDERAL REVENUE SHARING WITH THE STATES*

BY C. LOWELL HARRISS**

Proposals for a new form of Federal aid to State-local treasuries attract impressive support, both in and out of Congress. Each of the generally similar plans involve several elements. The broad outlines are identified with Walter Heller who, while Chairman of the Council of Economic Advisers, advocated such a new departure in Federal-State-local relations. Yet neither he nor anyone else has laid out a blueprint which receives widespread recognition as "the" plan, including the details which must be covered, one way or another.[1] Advocates seek combinations of objectives by combinations of methods, and rather differing combinations of each.

Two major elements can be identified: (1) a portion of Federal personal income tax (or of income reported for tax) would be turned over to State-local governments (2) for spending with little or no Federal guidance. The discussion which follows opens with a summary of the outlook for both Federal and State-local finances. The text then explores the bigger issues. Among them are such matters as the relative "qualities" of Federal and State-local revenue systems and the practical problems of implementing any plan, including the implications for use of Federal fiscal policy for broad economic stabilization. General purpose, as contrasted with tied, grants-in-aid, and problems of equalization, are examined. A brief discussion of possible alternatives concludes.

BACKGROUND AND MAJOR ARGUMENTS FOR THE PROPOSAL

The general setting envisaged by advocates of the plan naturally goes far to explain its features and the support behind it.

FEDERAL REVENUE GROWTH

Growth of the economy will raise Federal revenues (not counting trust fund receipts) by perhaps $6 to $8 billion a year without any increase in tax rates.[2] In a period not much longer than the 3 years since the signing of the Revenue Act of 1964, i.e., by 1970, Federal revenues seem likely to be $18 to $25 billion higher than today (early

*From Tax Foundation, Inc. Government Finance Brief No. 9, March 1967.

**Views expressed are those of the author and not necessarily of any organization with which he is associated.

[1] Several members of Congress have already introduced bills which do specify features in some detail. Differences are numerous. For simplicity, however, the discussion here will generally refer to "the" plan.

[2] The personal income tax applies at *progressive* rates to the *additions* to taxable income, and most income growth falls above the personal exemption (and deductions) and thus in the range of taxable income. The potency of this relation as a "revenue raiser" is greater than seems to be widely recognized. Moreover, almost half of any change in corporation earnings is offset by an opposite change in taxes; and corporation profits rise over time as national income grows.

1967) if present tax rates are unchanged. Economic growth, of course, will raise State-local revenues, but the growth from existing taxes at present rates will be less than Federal, perhaps $4 to $4.5 billion a year.

Expenditures, however, seem likely to present a contrasting picture. On the one hand, at the State-local level, pressures for large increases will appear year after year. In contrast, it is argued, the probable rise in Federal spending, excluding the uncertainties of national defense, will lag behind the increase in revenue.[3] A Federal budget surplus may appear within a few years. If defense spending were to stabilize, or to decline to "normal" Cold War levels, a surplus of record size could appear early in the 1970's.

Before proceeding further, let us note briefly what is essentially a side issue—that revenue sharing would help prevent "fiscal drag" on the economy resulting from a budget surplus. Such a surplus means that the Federal Government is taking more dollars from the income stream than are being replaced by Federal expenditure. Such net withdrawal may hurt the economy—or may help. The surplus is a form of saving. Holders of some Federal debt will be repaid. The effects of such debt retirement will depend upon other conditions prevailing at the time in the economy, especially the functioning of the capital markets. If they are functioning well, the funds will go to pay for capital projects which would not otherwise be possible. Thus, total demand for goods and services will not decline but will consist more of investment and less of consumption than if there were no budget surplus. The notion that a budget surplus will make funds idle and thereby depress the economy can be valid under some circumstances and yet wrong more often than not. The possibility certainly does not provide support for a *general*, more or less, permanent, program.[4]

Be that as it may, the rise in Federal revenues from existing tax rates *can* outpace the rise in Federal expenditures by enough to finance greater aid to States.

If Federal surpluses appear, and if State-local finances come under increasing strain, may it not be logical to use at least some of the Federal surpluses to finance State-local government?

GETTING MONEY TO STATE-LOCAL GOVERNMENTS

A portion of personal income tax receipts (or the equivalent) would be turned over to the States—*revenue sharing.* States have a long history of sharing revenues with localities, but Federal precedents are scanty.[5] The money would go in the form of *general purpose or unconditional grants* rather than being earmarked for one or another function and spent under Federal direction as is the case with present grants.

In effect, then, the Federal tax system would substitute to greater extent than at present for State-local taxes, while leaving States and

[3] Defense and social insurance both give rise to special problems for the present analyses. Defense outlays depend on developments not now foreseen. Social insurance costs, under present arrangements, will be met from their own revenue sources.

[4] Rate reduction, of course, is always a possibility. It can serve as effectively as revenue sharing or expenditure increase to eliminate any budget surplus which seems likely to accumulate funds for which there is no demand to finance private capital formation.

[5] Certain taxes collected in Puerto Rico are turned over to its treasury. Proceeds from use of the public domain are shared to varying degrees with the States in which the land lies.

localities as much discretion in deciding on how to *use* the money as if they themselves had raised it. Deciding on actual details of the distribution would present many problems. The formula for distribution might—or might not—be relatively generous for low income States. Many of the potentially significant differences in plans referred to earlier involve methods of distributing funds. Some supporters of sharing prefer to tie funds to specific functions, such as education, but without the detailed controls that would be associated with an expansion of present grants.

Expenditure-Revenue Outlook for State-Local Governments

Much of the case for tax sharing rests upon a belief that States and localities face a well-nigh impossible task in financing growing "needs" for service. But what, in fact, is the outlook? Though doubts are many, the picture which results from detailed study seems brighter than painted in the broad-brush projections on which reliance has been placed to date.

"NEED": A VAGUE CONCEPT

Before examining the new data, let us first note that the concept of "need" lacks precision and objectivity. Frequently, writers seem to assume, loosely, that *need* and *desirability* are much the same. Starting from this assumption, one will conclude that "needs" can never be met. Does not the expansive nature of human desires assure that an inexhaustible and perhaps unattainable set of worthy goals, will always lie ahead? This condition can prevail even though the underlying or basic purposes to be served by State-local spending will be increasingly satisfied. The things undone, the "unmet needs," will be of declining urgency.

POSTWAR RECORD

One thing we do know from the recent past. The postwar record is one of tremendous accomplishment by States and localities. What will their revenue systems enable them to finance in the future?

State-local government general expenditures rose from $34 billion in 1955 to $75 billion in 1965, an increase of 123 percent (compared with a 55 percent, $35 billion, rise in Federal direct spending, excluding trust funds.[6] Much of the increase was attributable to a 29 million (17.7 percent) growth in population plus a continuing rise in prices. Yet in this decade, and for the whole postwar period, no small amount of the rise in outlays, went to improve the quality of public education, highways, health services, and welfare on other programs.[7]

From 1955 to 1965 State-local taxes went up from $23 to $52 billion—and from 7.0 to 8.0 percent of a rising net national product. Nontax revenues, Federal grants, and net borrowing also rose. Clearly, the

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[6] State-local outlays not included in the category "general" are utility, liquor store and insurance trust expenditures. The total nongeneral expenditure rose from $6.6 billion in 1955 to $12 billion in 1965, an increase of 81 percent. Federal direct spending including insurance trust increased $49 billion in the same period, or 69 percent.

[7] In dollars of constant purchasing power, as measured by the Consumer Price Index, *per capita* State-local general spending rose 60 percent; using the Wholesale Price Index, the measure was 72 percent. Neither of these figures, nor one using the implicit price deflator for GNP will necessarily measure quality change in the sense of more services per capita. They all, however, indicate that the public did pay for a substantial increase in the combination of quantity and quality of State-local services. Welfare payments and other transfers will be considered services in this paper.

public has made increasing use of State-local revenue sources to pay for more State-local services. But what about the future? Will the public be able and willing to finance growing "needs"?

EXPENDITURE OUTLOOK

New Tax Foundation estimates indicate a brighter outlook than has generally been forecast on both the expenditure and the revenue sides.[8] One finds, for example, solid reason for expecting a relaxation of some forces which contributed to the postwar rise in expenditures. A backlog of needs from the Great Depression and World War II created unusual demands, and the population explosion accentuated the strains. But by 1966 the backlogs had been substantially removed—physically by new construction and in such other respects as raising salary levels of State-local employees to the average for the private sector.[9]

For the future demographic changes are more favorable than generally realized. The birth rate has declined, leading to slower growth in total population. Of special significance, public school enrollment will rise by only a small percentage of the rate which so profoundly affected spending on education after the war. In the decade through 1964, elementary-secondary school enrollment rose almost 12 million while in the 1964–74 period the rise will be less than 2 million. The annual rate of increase in population aged 65 and over will drop to around 1.6 percent annually in the 1965–75 period, compared with nearly 2.5 percent in the prior decade; and more of those over age 65 will receive social security benefits and thus put less demand on old-age assistance. The huge rate of increase in street-highway spending after initiation of the interstate and defense highway program will hardly be duplicated in the years ahead; maintenance costs will go up substantially, but the rise in capital outlays seems unlikely to approach the doubling in annual amounts from 1955 to 1965.

For these and other reasons, the *rate* of increase in State-local spending will slacken. Compared with the 1955–65 rise of 123 percent, Dr. Watters projects an 89 percent increase from 1965 to 1975, *assuming the same rate of improvement in quality*. The dollar amounts, it is true, will grow by more than in the last decade. Nevertheless, the increases due to forces now observable will be significantly smaller in relation to expansion of the economy than postwar experience has led us to expect.

REVENUES FROM STATE-LOCAL SOURCES

Existing State-local tax, and nontax, revenue sources will, of course, yield more each year in which gross national product rises. How much more? The yield response of the different State-local taxes to changes in national income cannot be predicted with as much precision as we might like.[10] Dr. Watters estimates that the total yield from revenue

[8] *Fiscal Outlook for State and Local Government to 1975* (summary in Government Finance, Brief No. 7; full report in Research Publication No. 6—revised series), Tax Foundation, New York, 1967.

[9] From 1948 to 1965 the average compensation of State-local employees rose 121 percent to $5,607 while that of employees in private industry rose 104 percent to $5,706.

[10] The record of experience includes the effects of (*a*) changes in tax rates; (*b*) the adoption of new taxes, and (*c*) changes in assessment and other administrative practices. Consequently, the revenue results of economic growth alone cannot be isolated with certainty.

sources existing in 1966 (without rate increases) will go up 85 percent from 1965 to 1975, a rise of $53 billion. The rate of increase would be almost equal to the percentage rise in GNP. It might, of course, be more or less, depending greatly upon the administration of the property tax, the assessment practices of local governments.

Present imposts, of course, do not exhaust the potentialities of State-local governments. The assumption of stable tax rates is in a sense unrealistic because some tax rates will go up. The property tax in many communities could yield substantially greater revenue without requiring effective rates which approach the rates applicable in many localities. Taxes now used in some places can be adopted elsewhere. Revenue-increasing changes of other types, such as broadening the coverage of sales taxes and improvement of administration, are possible. Where there is pressure for relatively large growth of spending, will not one or more of these developments occur? As they do, revenue yields will tend to exceed the projections.

FEDERAL GRANTS

Federal grants are expanding rapidly. New programs have come into being and older ones enlarged. State-local governments received $11 billion in 1965, up from $3 billion in 1955. At the end of another decade, 1975, the total as projected will be $30 billion. These increases, it must be emphasized, have already been legislated—built into the system but not, of course, beyond change.

SUMMARY

For State-local governments as a group, present taxes, plus Federal grants as now established, will finance not only the expansion of State-local spending which is associated with population growth and other "normal" change but also improvements in quantity and quality of service at a rate roughly equal to that of the last few years. On the basis of the assumptions in the Tax Foundation study, in both 1970 and 1975 State-local governments as a group will have more funds than needed to pay for the services projected. Per capita—note, *per capita*—spending in 1975 would be 69 percent above the 1965 level, with the per capita amount for education up 63 percent, that for welfare up 139 percent.

Aggregates, however, conceal wide variations among communities and States. Many jurisdictions, it would seem, will be able to improve services considerably and also reduce tax rates. In other cases "needs" will outpace revenues. For localities the intensity of pressure will depend in part upon the provisions of State aid programs. These now differ considerably and will undoubtedly change. States and localities will react differently in taking advantage of the opportunities which will lie within their power to use present taxes and tax rates to finance spending for a growing population—or to take some of the benefits of economic growth in the form of relief from increases in State-local taxes.

Even if we accept the surprising and relatively optimistic outlook as a basis for making policy, other questions will command attention.

Will revenues *really* go up as projected? "Should" there be even greater rise in State-local spending than implied in the projections? Although State-local taxes (plus existing Federal grant programs) may be able to "do the job," would greater reliance upon Federal revenue sources, and less on State-local, be generally desirable, *e.g.*, produce fewer of the bad results we must expect from taxes? Would it be wise to change the form of Federal grants without altering the totals projected? Some comments, but no exhaustive analysis, can be offered here.

OBSTACLES TO STATE-LOCAL TAX INCREASES

The projections of yield given above assume no increases in tax rates. Yet some rates must go up if particular communities are to meet their problems. Some advocates of Federal revenue sharing, however, believe that deliberate action by State, and especially by local, officials to raise tax rates (or assessment levels) will often encounter such serious obstacles that money will not become available for expenditure which is much needed. Opposition to heavier taxation and to more intensive use of non-tax-revenue sources exists even though, presumably, the spending to be paid for would be worth while to the community.

As States and localities have increased their tax rates and assessments, and added new taxes, have they gotten near the saturation point in the utilization of the traditional revenue sources? In boosting property taxes, it is sometimes said, localities have raised burdens so high that further increases would have unfortunate effects on local economies (greater than the benefits from the spending).

Conditions differ greatly. By any measure of the intensity of use of revenue sources, one finds large variations among States, and among localities within the same State. The experience of some suggests that others could make a greater tax effort without the adverse effects often predicted. This conclusion, stated so simply, can hardly serve as a basis for policy; each case involvse specific issues of the relation of the tax to the benefits from spending in the particular locality or State. Nevertheless, in not a few States and localities, "unused" taxpaying capacity exists, that is, capacity which can be used before tax burdens get as high as those already being carried in much of the country. There is no assurance, however, that such margins for taxation will match the growth of unmet "needs." Older cities and some newer suburbs, for example, may in different ways to very hard pressed.

State-local reluctance to raise taxes can rest on more than "normal" taxpayer opposition. Some businesses, business activity, and prosperous individuals have freedom to choose one location over another. Such mobility gives rise to fear on the part of responsible citizens that tax increases will induce weakening of the community's economic base. Do high or otherwise onerous taxes really lead taxpayers to flee from, or not enter or expand in, the State or locality? Will not the quality of governmental service reflect differences in tax costs? Evidence is inconclusive, and views differ, especially as to magnitudes. But there is no denying the fact that many legislators and officials do give serious weight to the possibility. They feel that it is risky to push tax rates (and assessment norms) much above those already prevailing, especially if taxes in "competing" areas are not also going up. Worries will

be justifiably great when the additional government services to be paid for with the added revenue will not be clearly worth the extra taxes to the businesses and individuals expected to pay.

Do such considerations, however, really put much of an obstacle in the way of tax increases? Perhaps there is a better question: Can we not assume that government services worth their cost will attract "economic capacity" no less than taxes will repel? Not necessarily, if only because taxes do not fall on precisely those who benefit. Moreover, even if it is agreed that benefits will equal tax cost, one may argue that not all spending which would be justified on this basis will be undertaken.

PROBLEMS OF EXPANDING EXPENDITURES

Some advocates of revenue sharing use a line of argument which rests upon theories that have gained considerable acceptance in academic circles. What the people of one community or State do will have effects outside—"spillover," "neighborhood," "third party," or "external" results. Each expenditure program, and each tax program, will exert influences other than those directly and clearly associated with the parties who make the decisions. For example, a highway crossing a State will be used, not only by residents of the State but will also benefit cross-country travelers. Such a highway may also be of potential military value, a benefit shared by the entire nation. Similarly, a State or locality may reap only part of the ultimate benefits from what it spends to educate its youth, since some will migrate to other parts of the country. Recognizing an inability to retain the full benefits of spending, the public, especially smaller units of government, will fail to approve as much expenditure on certain functions as would serve the interest of the Nation as a whole. In other words, even if taxpaying capacity would permit State-local governments to finance a considerable increase in quality of services, reluctance to do so may rest, logically, upon the inability to capture benefits equal to at least the local taxes.

Such arguments have some validity. How much? Measurement is impossible. The "something," the "spillover" potential, which unquestionably does exist may be of trifling amount. Nevertheless, the existence of such external effects, whether large or small, has been cited to influence action. It is argued, for example, that the common responsibility for defense, the constant movement of population, the interdependence of all parts of the economy, and the needs of citizenship—all these combine to make health, education, reduction of poverty, urban transit, etc., more nationwide, and less completely local, matters than Americans once believed. When some areas fail to provide good quality government service, people far removed may suffer at least a little. Perhaps, therefore, they would benefit by being made to pay for services all over the country.

Interdependence is very real. But can the recognition of such reality serve as a suitable basis for policy? Rarely can we evaluate spillovers—good and bad—with even a small modicum of confidence in amounts. Nevertheless, an unstated assumption that we can measure, at least roughly, such spillovers underlies part of the movement of placing increased reliance on National Government financing of State-local activites.

Relative Qualities of State-Local, and Federal Tax Structures

One argument made for the proposal to share Federal revenues is that the economy would then make relatively greater use of Federal taxes, chiefly the personal income tax, and reduce the reliance on State and local revenue sources. By generally accepted standards, it is argued, the Federal system is better. But is the case really clear?

Criticism of the property, consumption, and miscellaneous taxes on which States and localities depend heavily comes easily. Yet many condemnations of State-local revenue systems reflect rather uninformed acceptance of oversimplified generalizations.[11]

Who will not also criticize Federal taxes? The criticism, though different, may be about as well founded as that of State-local taxes. The conclusions drawn from informed comparison of the two systems will be less clearcut than frequently asserted. Many and widely varied elements must be considered—burden distribution in *all* its varied aspects; [12] effects on economic growth; influence on both short-run and long-run resource allocation, including the redirection of incentive for personal effort (*e.g.*, skill directed to avoid high income tax rates) and actual or alleged distortions of investment (whether from the property tax or a corporation rate of 50 percent); balance-of-payments effects; contribution to awareness of the cost of government; the actual roles played, if any, by different revenue sources in indicating the preferences of individuals valuing alternatives in expenditures; cost of compliance and administration; relation to benefit from spending; contribution to economic stability; regulatory and other nonrevenue effects.

All these and other considerations are relevant. To incorporate them properly in the analysis requires, among other things still lacking, (*a*) a basis for the balancing of goals which are very different in their inherent natures and (*b*) some grounds for judging the effects (per dollar of revenue?) of different taxes for achieving disparate objectives.

The real choices before us are *not* between entire revenue systems but *changes at many margins*—more or less use of this tax compared with others. As regards equity, for example, or the effects on resource allocation, the real issue will not be personal income taxation as a whole as against property or sales taxation as entities in themselves. Rather, the real issue will be the effects of changes involving, say, $3 to $5 billion a year. How would the effects of a cut of x percentage points at any of various parts of the income tax rate scale compare with the effects of differences in retail sales taxation of equal revenue amount?

Can one compare the effects of the top portion of high property tax rates with the effects of the top five points of the Federal corporation income tax? The part of the property tax falling on pure land rent (or its capitalized equivalent in land value) may well be the least harm-

[11] In the last few years more and more economists say a good word for a tax on value added, perhaps as a (partial) replacement for corporation income taxation. The arguments have much merit. To considerable extent, however, these same arguments also apply to a general retail sales tax of the type used by most States.

[12] More than the *existence* of regressivity is involved. Also to be considered are such things as the *amount* of either regressivity or progressivity, the weight of total burden on the poor (perhaps in relation to spending for their benefit), various kinds of differences in treatment of people in much the same general circumstances (horizontal equity), taxes in relation to benefit, quality of assessment, and so on.

ful element of the whole tax system (per dollar of revenue); the tax on land, according to respected economic analysis, is much to be preferred to the top five, or perhaps 10, points of the corporation tax rate. Property taxes do fall heavily on construction, including investment in housing. But income taxes have apparently rather favored investment in some forms of building—and certainly favor housing "expenditures" by owner occupants over other types of consumption. Such considerations illustrate why it is difficult to compare the effects of various changes, at the margins, in different taxes. Let us look further.

Critics of State-local taxes frequently base much of their case on the reputed regressivity with which the burden is distributed. Although the extent of regressivity cannot be determined with assurance, a recent Tax Foundation study helps. It uses better data than were available for earlier estimates. For all State-local taxes, the study found that for all families in 1961, there was little regressivity in the $3,000 to $7,499 income range. This range included more than half of the total number of families. Why is there concern over regressivity? Is not the basis of the most serious concern really the size of the tax burdens placed on the low-income groups? [13]

The Tax Foundation estimates of burden distribution in 1961 and 1965 are rather interesting in this respect. On the assumption that half of the Federal tax on corporation income falls on consumption (the other half on stockholders), this tax imposes about three times as much burden on families with income under $2,000 as do State general sales taxes.[14] For the group with incomes under $2,000, total Federal taxes were slightly less than were State-local. The Federal system imposes progressive burdens throughout the income classes, steeply progressive in some ranges.

Tentative as such estimates may be, do they not challenge some of the common conclusions? Parts of the Federal system impose burdens of the type for which State-local systems get criticized. When reduction of tax rates becomes possible, one way to mitigate tax burdens on lowest income groups would be to cut certain Federal tax rates.

Comparison of alternatives, as objectively and as realistically as possible, might lead to a clearer conclusion about the effects and the relative merits of whatever marginal changes of the tax structure are at issue. Much of one's final evaluation might depend upon what one assumes will happen to the quality of property tax administration. One's expectations about the prospects of reform of income taxation—*e.g.*, loophole closing—may also influence judgments; the present Federal income tax is not the model of equity sometimes implied by persons comparing Federal and State-local revenue structures.

Two considerations, among others, can be cited in favor of reducing the relative degree of reliance on Federal as compared with State-local taxes. (1) Cuts could be made in the top rates of the corporation income tax; the potential long-run benefits would be large per dollar of

[13] Those with higher incomes will pay more dollars, substantially more, even though the tax system is regressive. If a man with $2,000 income bears State-local tax of 14 percent, while the man with $20,000 pays 10 percent, the tax as regards these two is regressive. But the first man pays $280 and the second $2,000.

[14] The comparisons here deal with absolute amounts of tax and with tax as a percentage of income, not with taxes as percentages of total revenue. The corporation income tax yielded much more total revenue than did State retail sales taxes. Proposals for revenue sharing as such do not envision sharing of the tax on corporation income; but reduction of the rates of this tax would be a possible alternative to increasing funds for States.

revenue.[15] (2) Relief could be concentrated on low-income groups (but not the very lowest, who pay no Federal personal income tax) if this seemed desirable; in contrast, relaxation of pressures on State and local governments would have less predictable results, except that, in general, pinpointing and concentrating tax relief would rarely be possible.

In short, the widely accepted view that the Federal revenue system is superior to State-local systems may be true. Yet the marginal changes which would be involved in the revenue sharing proposal could be of many types. By no means all would have the effects commonly predicted by advocates of revenue sharing.

RELATING NEW FEDERAL AID DIRECTLY TO INCOME TAX BASE OR YIELD

Formal revenue sharing, or the tying of Federal aid directly to either Federal income tax collections or the tax base, would create problems not apparent on the surface. Five points warrant attention here.

(1) State and local treasuries would benefit automatically from growth of the economy. But unless the business cycle is a thing of the past—and who would feel safe in making such an assumption?—State-local revenue instability would increase, giving rise to a new disturbing element in budgeting. Many States, of course, have already learned to live with instability of income tax yields. Methods for local and State governments to deal effectively with additional cyclical problems are not beyond man's ingenuity. Some proposed plans include the use of trust funds, buffers, or other provisions for "lagging" disbursements in ways that would assure advance notice of changes and thereby aid in adjusting. The effectiveness of any such arrangement cannot be determined in advance.

(2) Another, less obvious, problem could prove more than troublesome. (*a*) If the distribution of funds (sharing) were to be a fraction of either Federal tax receipts, the Federal income tax base, or a broader measure such as adjusted gross income, State-local governments would gain a sort of vested interest in the Federal income tax provisions at the time the plan was initiated. Would not such a tie to the past (*i.e.*, a tie in 1970 and 1975 to 1967) impede some types of Federal tax reform? [16] Governors and mayors would have an interest which would not necessarily be in harmony with that of the taxpayer. Would they not even argue that part of the normal growth of the tax base "belongs" to them? State-local officials in their efforts to prevent change in the income tax exemption of municipal bond interest have given a foretaste of what to expect. Might they not oppose such possible desirable changes as increasing the personal exemption, redefining "income," altering deductions, or lowering rates? Perhaps a new sharing formula would have to be considered as an element of any appreciable change in the income tax. Modifying the Federal income tax is already difficult enough without burdening the process

[15] Forces distorting the allocation of resources would be reduced. For brief summary of the argument see C. Lowell Harriss, "Taxing—and Untaxing—Business," *Tax Review*, January 1965.

[16] The tie would not, under plans as now envisaged, be to the dollar figures of some base year but, rather, to a percentage or some such relation. The dollar amounts would rise over time, and State-local officials would naturally come to plan upon expected increases.

by adding a new complication. Revenue sharing tied to an income base would present fewer obstacles of the type at issue here than would a plan resting on receipts because the latter involves both the tax base and the tax rates.

(*b*) Use of one or another plan for altering the income tax for short-run anticyclical (or other) needs would probably present even more difficulties than up to the present. Adding such a complication would be unfortunate. The case for relatively speedy tax change (perhaps under arrangements set in advance) has merit, enough potential merit to call for efforts to remove, rather than to add, obstacles.

(3) If distribution were to be attempted on the basis of *geographical* location of either income or tax—a possibility not, it seems, incorporated in plans now receiving serious discussion—a source of dispute would be created. For most taxpayers no question would arise, but nevertheless troublesome difficulties are inevitable. *Residence* is almost certain to be the primary basis for assigning tax, or income, among the State. (*Origin* of income, a possible alternative, would present even more problems than residence, *e.g.*, for income from unincorporated business.) Presumably the typical taxpayer who had moved or whose residence was in doubt would have no interest whether State X or Y got the money. For State treasuries, however, the conflicts would have substance. To resolve them, some agency would need power of decision. Otherwise inconsistent State rulings about jurisdiction would arise, as in estate tax cases. Millions of people change residence each year. For the same taxpayer, withholding, residence, and filing of returns may be in different States.[17]

(4) The total amount to be distributed might be determined, not more or less automatically on the basis of a fixed formula—as now envisaged—but by votes of Congress, perhaps every year or so. Would not Governors and mayors, State legislators and city councilmen, have reason to press Washington for bigger totals than the prevailing formula would provide? Thus a new problem, or the accentuation of an older one, would be added to our political system.

Perhaps little is to be learned from particular events in the past which, though somewhat similar, were inevitably different in many respects. Nevertheless, a few sentences from the 1930 report of S. Parker Gilbert, Agent General for Reparations, dealing with German experience are of interest:

> These recent developments illustrate what is indeed the underlying fault in the whole system of transfers to the States and communes; namely, the division of responsibility as between the authority which collects the taxes and the authority which spends the money. . . . The States and communes, on their side, spend the money without having had any of the responsibility or odium of collecting it, and they have fallen into the habit of expecting the Reich to provide more and more money for them to meet their recurring budgetary deficits. One of the States, in fact, has recently entered additional transfers from the Reich as the balancing

[17] Conflict could also arise if the *formula* for distribution distinguished according to the geographical source of the tax. The personal income tax, of course, is progressive. The amount of either tax or taxable income attributed to a State (or other area) will not necessarily conform to what some persons will feel is fair or otherwise desirable as a standard for revenue sharing (directly or indirectly).

item in its draft budget, and with each new provisional settlement the States and communes generally unite to exert all possible pressure to get larger payments from the Reich as if the Government of the Reich were an external authority depending on some other body of taxpayers....

It is characteristic of the successive financial settlements that the payments to the States and communes are quite frankly regarded each time as a matter for political compromise, without reference to their real needs and without any serious effort to determine them by investigation and analysis. . . . in each of the 5 years beginning with 1924–25 the actual transfers have largely exceeded the amounts which, from the estimates prepared by the Reich or from its draft budgets, the States and communes were justified in expecting when they prepared their own budgets. . . . There is no question but that this series of excess transfers, particularly in the initial years, encouraged the States and communes to increase their activities and their expenditures, and led many of them into the practice of budgeting for deficits in the hope that these would be covered sooner or later by further transfers of revenue from the Reich.[18]

(5) The division of new grant funds between States on the one hand and their local governments on the other cannot but create confusion, controversy, and new divisive conflicts—yet also open opportunities which have great appeal to some advocates of "the" plan. Perhaps great things could be achieved by a new grant program with funds distributed on some new basis. Who will not dream of magnificent potentialities? The dreams will differ, however, and differ so much that no one can be even reasonably sure that the final compromise would appear attractive.

General Purpose Aid Compared With Expansion of Conditional and Tied Grants

An important feature of most versions of the plan is that the funds would be distributed as general purpose aid rather than as grants earmarked for specific programs. Some versions would direct that the funds be used for education or some function conceived so broadly as to be almost "general purpose." The issues involve, among other things, basic elements of politics, economic and social life, and intergovernmental relations. The nature and extent of centralization in government (and in society) are at issue.

Most students of grants-in-aid probably have mixed feelings about the general *principle* of earmarking or tying grant funds.[19] For one thing, the exercise of *control* will appeal, not only to the sense of responsibility for assuring that money is used effectively, the avoidance of waste in the use of dollars raised by Federal taxes. Another reason for supporting controls is the desire of each group supporting

[18] S. Parker Gilbert, *Report of Agent General for Reparation Payments*, Berlin, May 31, 1930.

[19] See William J. Shultz and C. Lowell Harriss, *American Public Finance*, 8th ed. (Englewood Cliffs: Prentice-Hall, Inc., 1965), Chs. XXII and XXIII. In the present debate the issue is not between a system of tied versus one of untied grants. The question of practical significance is *what to add* to an extensive grant system which will undoubtedly continue to earmark the vast bulk of grant funds.

a function—health research, elementary education, reduction of pollution—to advance a specific objective.

Yet, there is also appeal in the prospect of freedom, flexibility, and opportunity to adapt to diversity of local and State needs. This is a country of tremendous variety. How can we expect good results without taking account of diversity of many kinds—stage of development (old or new city), age distribution of population, prior outlays and nature of established programs, size of community, State-local relations, topography, climate, and many others?

Some governmental problems are clearly national and must be dealt with by a centralized organization. Beyond national defense (and aid for veterans and interest on the national debt) and whatever government is to do to influence the general level of employment and prices, there will be debate about the degree of *national* interest involved in actual or potential functions of government. If income is to be *redistributed* on a substantial scale by government (*e.g.*, by welfare aid financed by sharply progressive taxes) National Government must be used, in part because of the vulnerability of States and localities to competitive pressures arising out of differentials in taxes and spending. Otherwise, however, the national interest in what happens in this community and that can rarely be even a tiny fraction of the interest of the people on the spot.

Tied grants involve varying degrees of centralization. And centralization tends to locate authority far from the site of problems. As a result, difficulties of communication, to say nothing of other obstacles when the processes are those of government, preclude the persons who make major and even minor decisions from having any real understanding of the true situation. Standardized solutions are applied without adequate regard for variations which prevail over a huge economy.

Congress, for its part, can hardly formulate statutory rules which will deal efficiently with large differences over the country. A possible alternative, congressional grant of much discretion for centralized but flexible administration of a program, also proves difficult. For one thing, top level authorities cannot be familiar with the details of actual situations. For another, discretion leads to uncertainties. Moreover, communication failures diminish lower level incentives to criticize central actions and to propose solutions. The United States is so large, conditions so diverse, that on grounds of efficiency alone there must be a strong presumption against programs of nationwide scope.

Judging accomplishment presents another problem. Those in Congress and the executive branch who decide upon major policies and the most important of specific actions do not live where they can observe more than a tiny fraction of the results. Consequently, evaluation of program results can be far from realistic. If someone else is paying most of the bill, the person on the spot may have a biased impression of the worth of a program. Economy and efficiency are likely to suffer if performance is separated from the bearing of cost.

Although decisions in this country have favored, overwhelmingly, the tying of grants, both logic and the lessons of experience indicate that the case is by no means so one-sided. It seems to me that if there

is to be any substantial amount of intergovernmental transfer of money—and the amounts now committed are certainly substantial—the best results are to be expected if at least some funds are given unconditionally. Then the people on the spot will have freedom and opportunity to do what they believe is best, aided by technical advice from various sources, including but not limited to National Government.

Tied grants can, and in some cases probably do, release or "free up" funds which are raised by the recipient government, making them available for uses having no direct connection with the particular programs getting grants. Nevertheless, the effects of predominant importance will unquestionably center on the program aided. How can one possibly believe that these specific programs will always be those of highest priority in all areas? And who can believe that Federal direction will, on balance, always be beneficial, compared with what would develop in the absence of the control that attaches to specific grants.[20]

One reason for tying grants is belief that Federal influence can lead to better performance than if States and localities were left to themselves. Nevertheless, the proliferation of grant programs, the increasing detail and specification of particular features, and a growing awareness that administration presents formidable difficulties which are not within sight of solution, all these and other considerations are combining to reenforce older criticisms of tying grants. Frustrations over compliance and administration are growing. Problems have overwhelmed staffs; long delays in getting decisions seem inevitable, and then when the decisions are made, their quality is by no means up to the standards hoped for. Not enough qualified personnel are available to direct well. Procedures cannot be free from the problems of bureaucracy.

States and localities find that qualifying for aid involves no small expense. Costly planning and staffing are required for meeting the details inevitably associated with detailed programs. Special—and expensive—skills and staffs are needed to maneuver in Washington (and sometimes in regional centers having authority over the distribution of funds) to find what is potentially available and then to get the "just due." [21] No one can know how much inequity results from the failure of State and local governments, not all of which are relatively small, to satisfy Federal requirements. Members of Congress must use time to help governments in their districts through the mazes of officialdom.

Some frustrating and costly disadvantages of tying grants must be expected in the best of circumstances; and when circumstances are not the best—defects in drafting of statutes, staffs which include persons of mediocre intelligence and low horizons, personnel shortages,

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[20] Such control is inevitable. The debates over Federal aid to education contained many statements—even pledges?—by supporters of such aid that "control" would not accompany dollars. Yet was there any basis in logic or experience to accept such assertions? No—unless as may have been the case, advocates of aid were thinking of "control" as the exercise of sweeping, nearly full, authority when "only" (extensive and increasingly detailed) "influence" was to be exercised.

[21] A Midwest official of the Office of Economic Opportunity is quoted as saying: "It's almost impossible for anyone to get money from us—at least without a great deal of delay and frustration—if they don't have technical help." Another OEO official said, "The little indigenous committees in poor areas just don't understand the forms." *Wall Street Journal*, Nov. 22, 1966.

willingness to use discretion for political purposes, inability to raise funds needed for matching, delays in modernizing laws and regulations—the results will fall far below hopes.

Nothing on the horizon gives reason to believe that the system of established, tied grants will be converted *en masse* into a system of general-purpose aid. This conclusion is valid even though, as just indicated, there is much criticism of the extent and nature of details and even though there is desire for more freedom in the use of money coming through Washington.

To eliminate the most serious objections to tied grants, however, general purpose grants or general revenue sharing are not needed. The job could be done by consolidating grants into a few broad groups, not so broad probably as education, health, transportation, but into a number much smaller than at present. Here is a possible means of achieving one objective of some advocates of "the plan" without necessarily adopting other features.

EQUALIZATION (REDISTRIBUTION)

Some support for revenue sharing comes from belief that desirable "equalizing effects" would thus be achieved. Nevertheless, equalization in its *essentials* is irrelevant so far as concerns revenue sharing. Almost any desired increase or decrease in equalization, however that term is interpreted, can be achieved by modifying one or more existing revenue, grant, or spending programs.[22]

If the concern is with people (rather than groups of people organized as states or localities), then alteration of income taxes ought to accomplish any reasonable objective—except enlarging aid for the very poor. For the latter, a negative income tax has been suggested but is not needed. Welfare and other existing grants with their many distribution formulas offer countless opportunities for increasing, decreasing, or altering the pattern of equalization. General-purpose grants would not, of course, assure that the neediest would benefit, or benefit in amounts in line with the totals of added Federal funds. Who knows how the money would be used? Or how State-local taxes would be affected?

Table 1 presents estimates of the probable magnitudes of "equalization" from one plan, that of Dr. Pechman. He suggests that 10 percent of the total grant be set aside for distribution to the third of the States with the lowest per capita income (in proportion to population weighted by the reciprocal of per capita income). This distribution of $200 million of an assumed $2 billion grant is shown in column 2, while column 1 distributes the remaining $1.8 billion on a population basis.

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[22] For humanitarian and other reasons one may (or may not) favor further use of Federal finances for shifting economic benefits from higher to lower income groups. But if so, is not the proper concern people, not States (or areas)? There are residents of Mississippi with considerably higher incomes than some of the residents of Harlem or Los Angeles. Grants which discriminate among States on the basis of income can enable State and local governments to give differing amounts of goverment services or tax relief in recognition of poverty or low income. The Federal funds involved may in fact, or in only assumption, come from higher income groups. But any such equalizing results from actual programs are by no means certain. The Federal grant system has placed less emphasis on equalization than casual impression may lead one to expect. Today, however, equalizing elements are relatively greater than only a few years ago. See Advisory Commission on Intergovernmental Relations. *The Role of Equalization in Federal Grants* (Washington, 1964).

TABLE 1.—*Distribution of $2,000,000,000 general-purpose grant under formula to recognize need and tax effort, compared with tax burden, by State, 1965* [1]

[In millions]

	Distribution of $1,800,000,000 grant on per capita basis	Distribution of $200,000,000 grant to poorest 3d of States	Total grant on per capita and need basis	Total grant adjusted for tax effort	Amount of $2,000,000,000 Federal tax burden collected by State	Difference between total adjusted grant and tax burden
	(1)	(2)	(3)	(4)	(5)	(6)
Alabama	$32.2	$14.0	$46.2	$43.0	$21.2	$21.8
Alaska	2.3		2.3	1.8	2.4	-.6
Arizona	14.9	6.5	21.4	24.8	13.8	11.0
Arkansas	18.4	7.9	26.3	24.5	11.0	13.5
California	173.5		173.5	208.2	229.8	-21.6
Colorado	18.4		18.4	19.9	20.2	-.3
Connecticut	26.5		26.5	22.8	42.8	-20.0
Delaware	4.7		4.7	4.0	9.6	-5.6
Florida	54.2		54.2	54.2	53.0	1.2
Georgia	40.7	17.7	58.4	55.5	30.2	25.3
Hawaii	6.7		6.7	7.5	6.8	.7
Idaho	6.5		6.5	7.5	5.2	2.3
Illinois	99.4		99.4	84.5	136.0	-51.5
Indiana	45.5		45.5	44.1	47.2	-3.1
Iowa	25.7		25.7	28.5	23.8	4.7
Kansas	20.9		20.9	23.2	20.0	3.2
Kentucky	29.7	12.9	42.6	39.2	22.0	17.2
Louisiana	32.9	14.3	47.2	54.3	23.6	30.7
Maine	9.2	4.0	13.2	13.9	8.6	5.3
Maryland	32.8		32.8	29.2	41.0	-11.8
Massachusetts	49.9		49.9	48.4	66.6	-18.2
Michigan	76.7		76.7	78.2	89.6	-11.4
Minnesota	33.1		33.1	40.1	32.8	7.3
Mississippi	21.6	9.4	31.0	35.0	11.0	24.0
Missouri	41.9		41.9	34.8	46.0	-11.2
Montana	6.7		6.7	7.5	5.8	1.7
Nebraska	13.9		13.9	12.4	13.4	-1.0
Nevada	4.1		4.1	4.2	5.6	-1.4
New Hampshire	6.3		6.3	5.7	6.4	-.7
New Jersey	63.2		63.2	54.4	85.2	-30.8
New Mexico	9.5		9.5	11.0	7.6	3.4
New York	168.5		168.5	190.4	254.6	-64.2
North Carolina	45.9	19.9	65.8	62.5	32.4	30.1
North Dakota	6.1	2.6	8.7	9.7	4.2	5.5
Ohio	95.6		95.6	78.4	109.4	-31.0
Oklahoma	23.2	10.1	33.3	33.0	19.4	13.6
Oregon	17.6		17.6	18.3	18.8	-.5
Pennsylvania	107.5		107.5	96.8	125.6	-28.8
Rhode Island	8.3		8.3	8.1	10.0	-1.9
South Carolina	23.8	10.3	34.1	31.4	14.6	16.8
South Dakota	6.5	2.9	9.4	11.3	4.8	6.5
Tennessee	35.8	15.6	51.4	47.3	27.2	20.1
Texas	98.5	42.8	141.3	128.6	88.6	40.0
Utah	9.2		9.2	10.3	8.4	1.9
Vermont	3.8	1.6	5.4	6.5	3.6	2.9
Virginia	41.6		41.6	33.7	38.4	-4.7
Washington	27.9		27.9	29.6	31.4	-1.8
West Virginia	16.9	7.3	24.2	22.7	13.0	9.7
Wisconsin	38.7		38.7	46.1	40.0	6.1
Wyoming	3.2		3.2	3.4	3.6	-.2

[1] The formula is that proposed by Dr. Joseph A. Pechman. See text.

Source: U.S. Department of Commerce, Bureau of the Census, Office of Business Economics, and Tax Foundation.

Dr. Pechman also supports an allowance for "tax effort," something of an incentive feature; he would weight the grants by the ratio of the effort of each individual State to that for the average State (taking the ratio of State-local general revenues to State personal income as a suitable measure of tax effort). This adjustment is reflected in column 4 of the table.

Column 5 shows estimates of the amounts by which $2 billion of Federal tax receipts were collected from the individual States in 1965.

On the assumption that the future distribution would be the same, column 6 presents the difference between an individual State's share of a $2 billion grant on Dr. Pechman's plan and the State's Federal tax burden; in other words, the redistribution effect. Southern States would generally receive more than they would pay, with a high of $40 million for Texas; $31 million for Louisiana; $30 million for North Carolina; in millions, $25 for Georgia; $24 for Mississippi, etc. None of the States would gain as much as New York would lose—$64 million. The loss would also be substantial in other prosperous States; in millions, $52 in Illinois; $31 in Ohio and New Jersey; $29 in Pennsylvania, etc. Without the proposed adjustment for tax effort, the results would be markedly different in some cases, as can be seen from comparison of columns 3 and 4. Depending upon the formulas used, the equalization and the "incentive" effects can be quite different.

These estimates say, in effect, that if the choice is between the grant proposal and a reduction in Federal taxes on the basis of a flat percentage of present collections, the differences are as appear in column 6. However, a reduction of $2 billion in Federal taxes could be made on any of many patterns; some might give significantly different results from those shown here.

Comparing Alternatives

Since the "Heller Plan" was proposed in 1964, much has happened as regards the various problems which concerned its sponsors. For one thing, increases in spending on defense and other Federal programs have removed any spectre of "fiscal drag" for the near future. Some Federal excise taxes have been removed, others reduced; one result is an easing of the problem of taxpayers in supporting State-local governments. Payroll taxes, however, have gone up substantially, reducing ability to pay other taxes. Grant programs have been added and enlarged so that Federal funds will soon be flowing to the States in very much greater amounts than was expected in 1964.

In the making of decisions on these and other matters little consideration seems to have been given to revenue sharing as an alternative. Now, however, political forces seem to assure that the proposal will get more attention; it should be compared with alternatives. In doing so, what criteria should one apply?

CRITERIA

To begin, let us note an underlying theme: within 2 or 3 years more resources than are now committed will be available for governmental spending, tax reduction, or debt retirement. Disposing of these funds will make possible things not now provided for—but not everything which in some sense would be desirable. Choices must be made.

Many possible goals, criteria, and standards for comparison deserve consideration. Some, certainly, are more important than others, but evaluations of their relative significance will differ. Another complicating factor results from the fact that revenue sharing bears closer relation to some objectives and criteria than to others. The ordering below does not necessarily reflect any consensus on priorities among these criteria.

1. One issue invokes the size of total government influence in future American society. The larger the total of government spending, and the higher our tax rates and tax bills, the greater the influence of the political process. One more specific aspect of the size of governmental role raises consideration of the "level," Federal, State, and local. What, for example, are the implications of trying to alter the relation between the magnitude of Federal and of State-local spending, taxing, and other influence?

2. Special importance may attach to the role of cities and metropolitan areas vis-a-vis States or the National Government. The ramifications of the problems involved here warrant independent and careful study, and doubtless action; revenue sharing as proposed offers promise but is not obviously and clearly the best.

3. A third set of issues concerns the adaptability of each proposal to differing needs and desires for such things as freedom, responsibility, leadership, initiative, efficiency, and the development of capabilities of high order, distributed widely. How easily can each alternative be altered over time as conditions change?

4. Choices among plans, including the status quo, inevitably affect the relative reliance upon different revenue sources, *e.g.*, income, property, and consumption taxes. Are there considerations of importance in altering the weight attached to one or another type of tax? What will be the effects on the distribution of (after-tax) income plus the benefits from government services? Some effects can come directly, some indirectly, and by various means.

5. Moreover, national policy seeks high employment, price-level stability, and other such broad objectives; the economic effects of revenue sharing and other alternatives on stabilization (cyclical) and growth over time, including flexibility for adjusting to changing conditions, must be taken into account.

6. And, of course, costs of administration and compliance must be weighed.

The actual results of any proposal must not be assumed to be those which one or another advocate seeks. What one must seek to discover in the reality which develops will depend not only upon the specific features of one as against another plan but also upon changes elsewhere in the system of government finances as a result of the alternative chosen.

ALTERNATIVES

Although many variants of the general proposal may in a sense be considered as alternatives, the major possibilities are few. The one emphasized in the last 2 years has been the expansion of conditional, categorical, tied grants. Two other alternatives seem, for reasons which cannot be elaborated here, to offer little prospect of adoption on a material scale—(1) increased *direct* Federal expenditures on traditionally State-local functions, *e.g.*, public assistance or education, and (2) Federal relinquishment of revenue sources beyond the excise taxes given up in 1965. Two others, however, do command serious consideration.

1. One major alternative would be *reduction in Federal tax rates.* Under this approach revenues could continue to rise as appropriate for spending and other needs, but reduction in tax rates would enable

the public to retain a larger fraction of its income than otherwise. Such a policy would enlarge personal freedom—to increase consumption, saving, and investment. The "tax bite" on the lowest income groups now taxed could be removed. The distorting and other adverse effects of high tax rates could be reduced. The relative importance of the Federal Government, and of the coercion involved in taxation, would decline.

Would reduction in Federal tax rates, however, make it easier for those State and local governments needing more revenue than would be forthcoming from present systems to raise it on their own? Taxpayers being less heavily burdened by the Federal Government would certainly be better able to pay more State-local taxes. State legislatures and city councils, however, would encounter more difficulty in raising their own taxes than in cashing checks from Washington. The net results would depend upon the patterns of Federal tax reductions and the various State-local increases; but State-local governments would probably not add to their revenues (above what would otherwise occur) as much as the Federal reduction. A majority of the public, it seems right to assume, would prefer some increase in private consumption and investment.

2. Tax credits might be enlarged. The State-local revenue problem could be eased, it is held, by a liberalization of the provisions for treatment of State and local taxes in the computation of Federal tax liability. Taxpayers who wish to itemize State and local taxes might be allowed larger deductions. Or everyone might be given a credit against tax (not a deduction from income) for combined State-local tax payments. The credit might be limited to income tax or to the excess of some specified percentage of tax or taxable income. Many forms of tax credit can be devised. The Advisory Commission on Intergovernmental Relations would limit the credit to State income taxes, thus providing a powerful inducement for States without income taxes to adopt them and easing the problem of all States in utilizing personal income taxes.

Evaluation must depend upon the specific details. Differences in State-local tax structures would create practical difficulties. Where use of the property tax is relatively heavy, how would allowance be made for property taxes of renters? State and local governments should find it easier to increase their taxes in the knowledge that a larger portion of the increase than under present law would be taken up indirectly by the Federal Government. Other considerations, however, might keep them from boosting taxes, especially if existing taxes would absorb all of the credit allowed. The tax credit, unless specifically designed to avoid this result, would give greater relative advantage to the higher income States. The actual revenue-raising responsibility would remain at the State or local level. Spending decisions would be free from Federal direction.

Concluding Comment

Subject to uncertainties growing out of defense spending, it seems clear that Federal revenues will be enough higher within 2 or 3 years to permit tax rate reduction, more expenditure than now scheduled,

debt reduction, or some combination of these three. State-local revenue systems, plus Federal grants-in-aid as greatly enlarged in recent years, will enable States and localities as a group to finance spending programs to provide for population increase and other foreseeable changes, with additional funds for quality improvement. Some communities will unquestionably face strain. The general outlook, however, by no means presents the crisis elements which helped give rise to proposals for Federal revenue sharing. The other arguments for, and against, income tax sharing as compared with the alternatives do not lead to a clear conclusion. Different observers will properly attach different weights to the various relevant elements. Serious discussion, it is hoped, can continue.

UNCONDITIONAL GRANTS-IN-AID*

BY GEORGE F. BREAK

From its secluded existence in the world of fiscal theory the suggestion that the Federal Government should offer unrestricted grants-in-aid to the States burst suddenly into the public arena during the fall of 1964. Sponsored in different forms by Presidential candidate Goldwater and by a task force appointed by President Johnson, the proposal enjoyed a brief period under the klieg lights and then retired, somewhat battered, into the quieter regions from which it had come.[1] Clearly, the plan possessed both merits and weaknesses that attracted widespread attention, and the purpose of this chapter is to appraise those qualities and to compare unconditional grants with other ways of achieving the same goals. This will involve, among other things, an analysis of the equalization powers of existing Federal grant-in-aid programs.

BALANCING GRANTS

Unrestricted intergovernmental grants are ideally suited to offsetting, or balancing, any general fiscal deficiencies to which State or local governments may be subject. These deficiencies can arise for two reasons. The first is that a high concentration of low-income families tends to make the cost of providing even an ordinary level of public services prohibitive, to say nothing of the additional services that such families typically require from government. One can easily visualize the problem that would face a locality made up entirely of families which received, say, only $2,000 a year—a figure which might represent the minimum cost of an acceptable level of private consumption alone. If this were the case, the community would have no ability whatsoever to support government services, such as public schools or fire protection, which, being indispensable, would have to be financed somehow. While functional grants, made to finance education, vocational training, relocation of economic activity, and the like, would be the obvious solution, they could not exert their effects quickly. In the short run, therefore, the community would need large amounts of outside general assistance with its fiscal affairs. Nor does past experience indicate that the short run would necessarily be very short. Even with vigorous State and Federal antipoverty programs, it might be a generation before the community could afford

* Reprinted from: George F. Break, *Intergovernmental Fiscal Relations in the United States*, The Brookings Institution, Washington, D.C., 1967, Chapter IV.

[1] The original idea came from Walter W. Heller, who recommended unrestricted Federal grants to the States as a method of reducing the "fiscal drag" generated by rising Federal receipts under conditions of rapid and sustained economic growth. (See *U.S. News and World Report,* June 29, 1964, p. 59.) The task force submitted its report in November 1964, but details of the report have never been released. The views of Joseph A. Pechman, who served as Chairman of the task force, are given in "Financing State and Local Government," *Proceedings of a Symposium on Federal Taxation* (American Bankers Association, 1965; Brookings Institution Reprint 103, 1965). For Professor Heller's detailed views, see his *New Dimensions of Political Economy* (Harvard University Press, 1966), ch. III.

on its own what is currently regarded as the standard set of local government services, and by that time the Nation might well have adjusted its standards still higher.

The second type of fiscal deficiency arises from what many regard as a fundamental gap between State-local spending responsibilities and their revenue-raising abilities. Even the richest States, it is argued, cannot levy enough taxes to finance the program expansions that are justified by the benefits that could be obtained from them. One's view of this matter obviously depends both on the importance one attaches to State and local programs such as education, urban renewal, environmental health, and on the extent to which one believes that State and local taxes are held down by fears of interstate competition for business and wealthy residents rather than by a lack of initiative in developing new and better tax bases. These complex issues have been discussed at length in earlier chapters. Suffice it to note that if this second kind of fiscal deficiency were the only one to be dealt with—that is, if each State government's resources were adequate for its fiscal needs but not fully exploitable—the appropriate solution would not be grants-in-aid at all but some form of tax sharing whereby revenues were returned to the jurisdictions of origin. Either centralized tax administration or tax credits would accomplish the purpose desired. (See ch. II.) Given the presence of both kinds of fiscal deficiency, however, a single program of unconditional grants would provide one effective means of dealing with both difficulties at once. Such a solution would also have the great political appeal of granting assistance to every State, or to every local government within a State, whereas a pure set of equalizing grants would go only to the poorest jurisdictions.

The function of unconditional intergovernmental grants-in-aid, then, is to offset whatever fiscal deficiencies exist at the State and local level. Of the two kinds of deficiencies that can be balanced in this way, the more basic is the one that arises from geographical concentrations of low-income families and individuals, since without it there would be no justification for unconditional grants. The next section, accordingly, considers the interstate differentials that currently exist in fiscal needs and resources.

TABLE IV–1.—*Regional per capita personal income in 1929, 1948, 1957, and 1963*

Region [1]	Per capita personal income as a percentage of the national average			
	1929	1948	1957	1963
United States	100	100	100	100
Mideast	138	116	117	115
Far West	129	120	117	118
New England	125	106	112	113
Great Lakes	114	112	110	107
Rocky Mountain	85	98	92	92
Plains	81	100	91	95
Southwest	67	83	87	83
Southeast	52	68	71	74

[1] Ranked by their 1929 order.

Source: Robert E. Graham, Jr., *Factors Underlying Changes in the Geographic Distribution of Income,* Survey of Current Business (April 1964), p. 21.

Interstate Differences in Fiscal Capacity

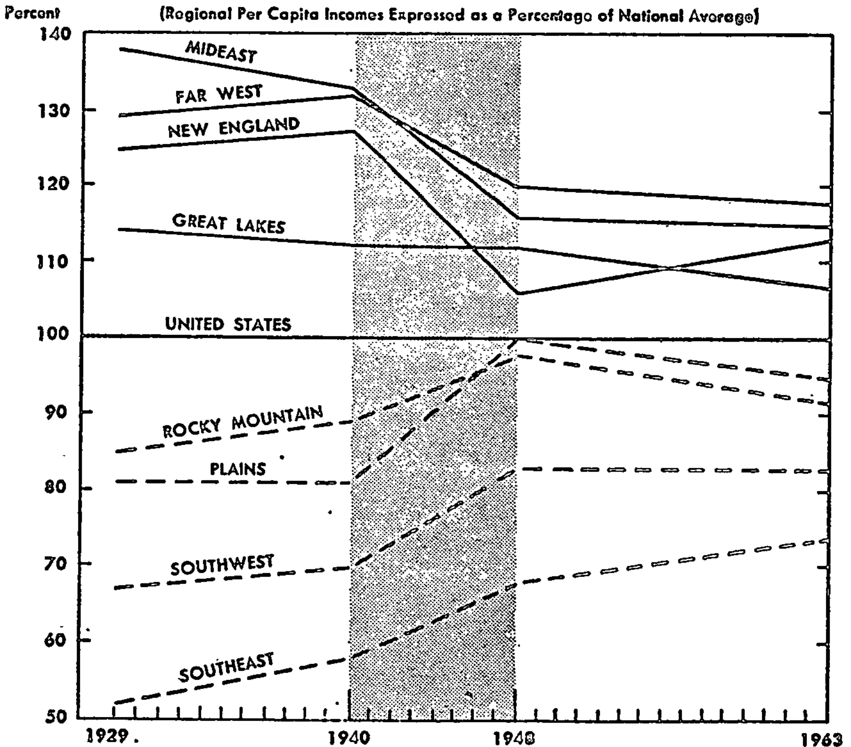
Since 1929 there has been a dramatic reduction in per capita income inequality among the States. As table IV–1 shows, per capita personal income in the country's richest region fell from 138 percent of the national average in 1929, when that region was the Mideast, to 118 percent in 1963, when the Far West had taken over top place; while during the same period per capital income in the poorest region, the Southeast, rose from 52 to 74 percent of the national average. There was, in other words, more than a 40-point reduction in the maximum regional income differential. Most of the change, however, occurred during World War II and the immediate reconversion period. This can be seen both in figure IV–1, where the trends in relative regional per capita income are shown, and in the following tabulation of changes in the coefficient of variation for State per capita income:

1929	32	1946	18	1957	18
1940	29	1948	18	1963	[2] 16
1944	20	1953	19		

[2] Robert E. Graham, Jr., *"Factors Underlying Changes in the Geographic Distribution of Income,"* Survey of Current Business (April 1964), p. 30. The coefficient of variation is the mean difference between per capita income in each State and in the Nation as a whole, these differences being taken without regard to sign, weighted by population, and their average then expressed as a percent of U.S. per capita income.

FIGURE IV-1. Relative Regional Differences in Per Capita Personal Income, 1929–63

Regional Differences in Average Income Levels Narrowed Sharply During World War II and Reconversion; Since Then Convergence Has Been Small



Source: U.S. Office of Business Economics, *Survey of Current Business* (April 1964), p. 25.

Particularly notable is the 9-point drop in this measure of income inequality between 1940 and 1944 and its virtual stability from 1946 to 1957.

Two aspects of postwar regional income trends are particularly important for our purposes. The first is that whereas the industrial structure that existed in 1948 would, by itself, have acted to widen interregional income differentials, these industry mix effects were typically swamped by the more important and opposing effects of interregional changes in industry shares. The regional impact of these two sets of forces is summarized in table IV-2. This table shows that the industry-mix effects, which show the extent to which the industries existing in a given region in 1948 grew more or less than the average for the country as a whole thereafter, are all positive for the four regions with above-average per capita income and all negative for the other four regions.[3] Three of the four regions that gained a greater share of total industrial activity between 1948 and 1962, in contrast, fell at the bottom of the income scale, and in each case these regional-share effects were more important than the opposing industry-mix effects. It would appear, therefore, that changes in the location of industrial production, at least in the broad sense of the differential regional growth rates exhibited by given industries, favored the low-income States during this period. Since unconditional Federal grants-in-aid, if enacted, would presumably do the same thing, their probable impact on industrial location would be to accentuate trends already underway.

TABLE IV-2.—*Industry-mix and regional-share effects on income from participation in current production, by region, 1948–62*

[In billions of dollars]

Region [1]	Changes in total participation income [2] due to—		
	Industry mix effects	Regional share effects	Net effect [3]
Far West	1.8	8.0	9.8
Mideast	5.4	−9.8	−4.4
Great Lakes	1.5	−8.1	−6.6
New England	1.1	−1.7	−.6
Plains	−4.4	−.3	−4.7
Rocky Mountain	−.7	1.3	.6
Southwest	−.7	3.5	2.8
Southeast	−3.9	7.2	3.2

[1] Ranked by per capita income in 1948.
[2] Consists of wages and salaries, supplementary labor income, and earnings of self-employed persons. On the average it constitutes 80 percent of total personal income.
[3] Sum of the preceding 2 columns. Figures are rounded and may not add to totals.

Source: Robert E. Graham, Jr., *Factors Underlying Changes in the Geographic Distribution of Income,* Survey of Current Business (April 1964), p. 24.

The second notable postwar development is the extent to which population growth and income growth have been matched geographically, thereby producing a high degree of stability in per capita interstate income differentials. Two States provided a vivid illustration of these trends. Between 1948 and 1963 California gained 7.5 million people and tripled its total State income. Over the same period West Virginia lost 121,000 residents and suffered a one-third decline in its

[3] Agriculture, which is highly concentrated geographically and which had a negative rate of growth during the period, dominated the industry-mix effects. *Ibid.,* p. 23.

share of the country's total income. Yet California's per capita income was virtually the same percentage of the national average in 1963 as it was in 1948 (122 percent compared to 123 percent in 1948), and West Virginia's position had declined only from 81 percent of the national average in 1948 to 77 percent in 1963. One population movement that did affect State per capita income, however, was the migration of Negroes with their below-average income from the South to the North and West, and primarily from the five States of North and South Carolina, Georgia, Alabama, and Mississippi to New York, Illinois, and California, and in somewhat lesser numbers to New Jersey, Michigan, Ohio, and the District of Columbia. The result was a spillover of the costs of inadequate public education that should whet the appetite of the in-migration States for Federal grant assistance, not only to themselves to help with the immediate problems of poverty but especially to the South, where any longrun solution to the problem must be found.

TABLE IV–3.—*State per capita personal income as a percentage of the national average in 1963*

State	Percent	State	Percent
District of Columbia	139	Iowa	93
Nevada	138	Montana	92
Delaware	133	Kansas	91
Connecticut	129	Utah	87
New York	123	Arizona	87
California	122	Florida	86
Illinois	121	Vermont	86
New Jersey	119	Virginia	85
Massachusetts	117	Texas	84
Alaska	115	North Dakota	83
Maryland	114	Maine	82
Michigan	103	Oklahoma	80
Oregon	103	Idaho	79
Missouri	103	South Dakota	79
Washington	103	New Mexico	77
Ohio	102	West Virginia	77
Hawaii	101	Georgia	76
Indiana	101	North Carolina	74
Pennsylvania	100	Kentucky	73
Wyoming	99	Tennessee	73
Rhode Island	98	Louisiana	72
Colorado	98	Alabama	68
Wisconsin	97	Arkansas	65
Minnesota	95	South Carolina	65
New Hampshire	94	Mississippi	56
Nebraska	94		

Source: Robert E. Graham, Jr., *Factors Underlying Changes in the Geographic Distribution of Income,* Survey of Current Business (April 1964), p. 21.

Though the interstate distribution of per capita income is clearly less unequal now than it was in earlier years, it still shows a very wide dispersion that implies major differences in State fiscal capacities. In 1963, for example, Mississippi's per capita income of $1,379 was only 56 percent of the national average ($2,443) and barely 40 percent of the $3,398 and $3,372 averages enjoyed by the residents of the District of Columbia and of Nevada, respectively. Table IV–3 fills out this picture by ranking the States by their 1963 per capita income. One must, of course, be cautious about inferring fiscal capacities from per capita income figures alone. Two States that are equal in per capita income may have very different distributions of family income and therefore different abilities to raise revenue by either progressive

or regressive taxation. In addition, interstate income may be taxed more frequently by the State of origin than by the State of residence, and some of the most important State and local taxes are levied on bases that differ in relation to income from one State to another.

TABLE IV–4.—*4 measures of State fiscal capacity and actual tax collections, by States, 1959 and 1960*

[Per capita as a percent of the U.S. average]

Region and State	Personal income, 1959	Income of above-minimum families, 1959	Income produced, 1959	Yield of representative tax system, 1960	Actual tax collections, 1960
New England	111	110	101	97	109
Maine	83	81	72	78	99
New Hampshire	92	97	83	98	93
Vermont	83	81	78	85	110
Massachusetts	113	112	105	96	116
Rhode Island	100	98	89	87	98
Connecticut	129	130	115	112	105
Mideast	116	115	114	100	115
New York	125	122	128	105	143
New Jersey	120	125	111	105	102
Pennsylvania	102	100	97	91	87
Delaware	136	114	97	112	98
Maryland	108	110	94	93	99
District of Columbia	133	129	159	126	107
Great Lakes	107	108	109	105	100
Michigan	104	105	101	99	109
Ohio	106	106	106	103	94
Indiana	97	99	102	101	89
Illinois	119	119	126	116	102
Wisconsin	98	100	96	97	107
Plains	92	90	96	107	96
Minnesota	91	93	97	103	108
Iowa	91	88	96	114	103
Missouri	100	93	103	99	75
North Dakota	72	72	80	108	99
South Dakota	70	69	81	107	99
Nebraska	91	87	100	119	86
Kansas	92	95	87	113	108
Southeast	72	71	73	76	71
Virginia	83	85	85	81	68
West Virginia	76	71	81	74	75
Kentucky	70	69	74	74	59
Tennessee	70	68	69	71	67
North Carolina	69	66	76	72	69
South Carolina	62	59	60	60	64
Georgia	72	71	74	69	70
Florida	91	94	83	101	91
Alabama	66	65	65	66	60
Mississippi	53	48	48	57	64
Louisiana	74	72	81	88	93
Arkansas	61	56	56	69	62
Southwest	87	88	95	113	84
Oklahoma	83	85	89	94	88
Texas	88	87	96	120	80
New Mexico	84	87	92	102	86
Arizona	89	98	96	99	103
Rocky Mountain	94	97	97	116	108
Montana	92	91	96	129	111
Idaho	83	87	84	108	96
Wyoming	104	103	108	161	118
Colorado	101	103	101	114	114
Utah	86	93	96	101	100
Far West	118	123	116	119	133
Washington	104	111	102	102	100
Oregon	102	105	94	103	116
Nevada	126	130	142	146	136
California	124	128	121	126	138
Alaska	117	126	117	69	80
Hawaii	96	103	96	76	117

Source: ACIR, "*Measures of State and Local Fiscal Capacity and Tax Effort*" (October 1962), pp. 54–55.

To illustrate some of these differences, table IV–4 gives four alternative measures of State fiscal capacity that were developed recently by the Advisory Commission on Intergovernmental Relations (ACIR).

In the first column is the series based on Department of Commerce estimates of State per capita personal income, and in the second is a series that uses Bureau of the Census data on above-minimum family and individual incomes. By excluding income received by families with less than $2,000, and by individuals with less than $1,000, a year, the latter measure concentrates more precisely on personal abilities to pay taxes,[4] but in order to do so it has to use statistical data that, being derived from personal interviews, are probably less accurate than the Department of Commerce personal income estimates.[5] The second column in the table, in other words, is not necessarily superior to the first as a measure of State fiscal capacities. In any case, it may be noted that the differences between the two are not great.[6]

Income produced is of interest as a potential allocator of Federal equalization grants because State and local systems tend to tax income flows at their origin rather than at their destination.[7] To use it in this way would, as table IV-4 shows, favor most of the New England and Mideast States as well as Florida, Mississippi, Kansas, and Oregon. Most of the Plains, Southwestern, and Rocky Mountain States, in contrast, show lower fiscal capacities when the measure of these is personal income than when it is income produced.[8] As allocators of Federal grants, then, the two series would clearly give different results, so it is important to decide to what extent they should be used. On theoretical grounds each has a strong claim, but pragmatic considerations, at least for the immediate future, give the choice overwhelmingly to personal income because estimates are more available and reliable.[9]

All three of the measures discussed so far deal with State fiscal capacities in the abstract—that is, with the economic bases that are theoretically available to State and local governments for tax purposes. For political and other reasons, however, tax practice may depart significantly from economic principle. The policymaker may wish an index of fiscal capacity that takes these differences into account. Such a measure is provided by the Advisory Commission's

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[4] A still more precise measure would be one based on an index of family welfare that expressed total household resources as a percentage of the cost of basic household needs. which would be a function, among other things, of family size, family composition, and the prices of necessities in different parts of the country. For a discussion of such an index and a demonstration that it differs significantly from per capita disposable income as a measure of family welfare, see Martin David, "Welfare, Income, and Budget Needs," Review of Economics and Statistics, vol. 41 (November 1959), pp. 393–399.

The fiscal capacity of a given State would be a function of the per capita income received by all families residing in it that had a welfare index greater than unity, and a measure of special needs for public services (or subsidies) could be derived by estimating the additional amount of income needed to bring all families with indexes below unity up to that level.

[5] The large difference between the two income relatives for Delaware (136 versus 114), for example, probably reflects the well-known difficulties involved in obtaining accurate information about high family incomes by means of interview surveys.

[6] Only twelve states exhibit differences as large as five points between the two measures. If Bureau of the Census data for all families are compared with those given in column 2 of table IV-4, thereby isolating the effect of excluding low-income families and individuals, only Arkansas, Mississippi, and Tennessee show differences as great as three points. See ACIR, *Measures of State and Local Fiscal Capacity and Tax Effort* (October 1962), p. 54.

[7] This is especially true of corporate profits levies, but it also applies, in varying degrees, to property, sales, and other business taxes, and even State individual income taxes tend to favor the State of origin by giving credits for taxes paid elsewhere more frequently to residents than to nonresidents.

[8] North Carolina, Louisiana, and Nevada also fall in this category.

[9] Allocating national income produced to the different States, in which the National Planning Association has pioneered, is subject to all of the difficulties, both theoretical and statistical, noted in ch. II. The series given in the third column of table IV-4, which is derived from NPA estimates, should be regarded only as a first approximation to the measure desired. ACIR, *Measures of State and Local Fiscal Capacity and Tax Effort*, p. 25.

estimates of the yield of the Representative State and Local Tax System in 1960, given in the fourth column of table IV-4. To derive the series the Commission first selected all those taxes which in 1960 either were used by States with more than half the total population of the country, or were used by States accounting for more than half of the nationwide potential tax base.[10] It then applied to each of the selected tax bases in each State an average tax rate equal to the rate prevailing in the country as a whole in 1960. This means, for example, that in the Representative Tax System each State is assumed to levy a general retail sales tax at a uniform tax rate (2.9 percent) sufficient to produce for all 51 States (including the District of Columbia) the same 1960 sales tax revenues as were received in that year by the 37 States that actually did impose general sales taxes.[11] Similar procedures were followed for each of the other taxes included in the Representative System. The result is a measure of fiscal capacity that differs considerably from either personal income or income produced. In general, the Representative System approach attributes greater taxpaying abilities to the Plains, Southwestern, and Rocky Mountain States, and lower abilities to the Mideastern and some of the New England States, then either of the income series.

The Advisory Commission suggests several reasons for these differences, but the most important appears to be the well-known tendency, arising from variations in the rate of return on different types of wealth, for the burdens of a tax on property—which plays a dominant role in the representative system—to be distributed differently from the burdens of a tax on income. In the present instance, it is the relatively low postwar rate of return on farm property that has given the predominately agricultural States in the West and Southwest a greater ability to raise taxes on the basis of wealth than on the basis of income.[12]

It is important to note that population, used as a divisor in each of the measures of fiscal capacity so far discussed, performs a dual function. Not only does it convert aggregate income into a meaningful index by which each State can assess the ability of its inhabitants to pay taxes, but it also serves as a rough measure of their need for public services. To allocate Federal grants according to the reciprocal of State per capita income, for example, would be to distribute the funds simultaneously on two different bases—directly in relation to need and inversely in relation to fiscal capacity. The great advantage of using population in this way lies in the simplicity and ready availability of estimates rather than in any inherent superiority.

Numerous refinements in per capita income figures can be conceived of, but for one reason or another only a few could be used to good effect at the present time. Consider, for example, four different characteristics of a State's population that are all positively related to its need for most kinds of public services: the ratio of young and old people to those of working age, the percentage of the population with very low incomes, the density of its geographical distribution, and its rate of growth in the recent past. Measures of the first two "needs"

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[10] Both severance taxes on gas and oil and stock-transfer taxes meet the second test but not the first.

[11] For further details concerning the derivation of the Representative Tax System see ACIR, *Measures of State and Local Fiscal Capacity and Tax Effort*, pp. 31–51, 107–121.

[12] *Ibid.*, pp. 56–71.

factors appear to be rather closely related to State per capita income (table IV-5); their addition to the grant allocation formula would probably not change its operation materially. The 10 States with the highest percentages of dependent and low-income people in 1959-60, for example, also had very high average rankings (41 and 46, respectively) in the State distribution of per capita income (using 1 for the highest income State and 51 for the lowest, whereas the corresponding ranks for the 10 low-need States were only 8 and 9.

Rapid population growth, on the other hand, has characterized some high-income (Delaware, Nevada, and California) as well as some low-income (New Mexico and Utah) States, but it does not appear to have a consistently important effect on the level of all kinds of State and local expenditures.[13] Population density, however, is a major determinant of city expenditures that is not closely correlated with per capita income.[14]

TABLE IV-5.—*Ratios of dependent population to working-age population and of low-income families to all families, 10 highest and 10 lowest States, 1959-60*

State [1]	Percent of dependent to working-age population [2]	State [1]	Percent of low-income to total families and individuals [3]
10 HIGHEST STATES			
Mississippi (51)	122	Mississippi (51)	42
Utah (33)	118	Arkansas (50)	38
North Dakota (44)	114	South Carolina (49)	32
South Carolina (49)	114	Alabama (48)	31
South Dakota (40)	113	Kentucky (46)	31
New Mexico (39)	112	Tennessee (47)	30
Arkansas (50)	110	North Carolina (45)	29
Montana (29)	109	Louisiana (42)	28
Vermont (36)	109	Georgia (43)	27
Louisiana (42)	109	West Virginia (41)	27
10 LOWEST STATES			
District of Columbia (2)	74	Connecticut (3)	11
Nevada (4)	82	New Jersey (8)	12
New York (5)	83	Nevada (4)	12
New Jersey (8)	84	Hawaii (19)	12
Connecticut (3)	88	Alaska (7)	12
Pennsylvania (17)	90	California (6)	13
California (6)	90	Wyoming (15)	13
Illinois (9)	90	Massachusetts (10)	13
Rhode Island (20)	91	New York (5)	14
Alaska (7)	92	Washington (14)	14

[1] Number in parentheses is the rank of the State in per capita personal income in 1959-61 (high to low).
[2] Population under 21 years of age and 65 and over as a percent of the population 21 through 64 years of age in 1960.
[3] Families with incomes below $2,000 and unrelated individuals with incomes under $1,000 in 1959 as a percent of total number of families and unrelated individuals.

Source: ACIR, *Measures of State and Local Fiscal Capacity and Tax Effort*, pp. 24, 99.

[13] Glenn W. Fisher, for example, found population increase during the 1950's to be significantly related to 1960 per capita State and local expenditures for local schools, police, general control, and interest payments (positively) and highways (negatively), but not to higher education, public welfare, health and hospitals, fire, or sanitation. See "Interstate Variation in State and Local Government Expenditures," *National Tax Journal*, vol. 17 (March 1964), pp. 57-74.
Harvey E. Brazer, on the other hand, found population growth during the 1940's to be significantly related only to 1951 city expenditures for fire and for general operating purposes, and in both cases the correlation was negative. See *City Expenditures in the United States*, Occasional Paper 66 (National Bureau of Economic Research, 1959), p. 25.
[14] *Ibid.*, pp. 67 and 76.

By any measure used (and State per capita personal income seems to be the best single choice currently available) interstate differences in both fiscal capacity and the need for public services are clearly very wide. A marked lessening in inequality did occur during World War II, but it has proceeded at a much slower pace since then and gives no sign of accelerating in the near future. Many people would consequently regard the existing degree of interstate inequality as sufficiently great to establish a strong prima facie case for a comprehensive program of Federal equalization grants. Some elements of such a program already exist, but as will be seen in the next section, they are still haphazard and relatively unimportant.

The Equalization Powers of Existing Federal Grants

Taken as a whole, Federal grants-in-aid tend to be concentrated neither in the wealthy nor in the poor States. In 1961–62, for example, the correlation coefficient between per capita Federal grants and per capita State income was slightly negative (−0.04) but not statistically significant.[15] As will be seen below, however, this rough proportionality to income resulted not from a homogeneous set of grant programs but rather from the combination of a minority with significant equalizing effects and a majority of the opposite nature.

It is often argued that Federal grants have significant redistributional effects because they are financed by progressive Federal taxes. Measurements of these effects are then made by allocating Federal taxes among the States on the basis of standard assumptions as to tax incidence.[16] In my view, however, such measurements are likely to be more misleading than helpful. In the first place, they assume unjustifiably that fewer Federal grants would mean lower Federal tax receipts rather than higher Federal expenditures of other kinds. Which of these two results is the more realistic cannot be determined, but the possibility of grant-expenditure substitutions seems far too important to be eliminated from consideration. Second, even if new grants do induce higher Federal taxes, the nature of these taxes is usually unknown; they could be either considerably more or considerably less progressive than the Federal tax system as a whole. To assume that any additions to the Federal tax system will exactly reproduce the redistributional effects of the system may well be the only way to derive a quantitative measure of the equalizing effects of grant-financing taxes, but it hardly contributes to one's confidence in the usefulness of that measure.

Finally, lack of knowledge about the true incidence patterns of both corporate income taxes and excise taxes means that even meas-

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[15] ACIR, *The Role of Equalization in Federal Grants* (January 1964), p. 63.

Somewhat larger negative coefficients were obtained for 1952 and 1959 (−0.09 and −0.26, respectively) by M. A. Haskell, but he went on to show that the negative association disappeared entirely when population density was introduced into the analysis. In his three-variable model, Federal grants were inversely related to population density (mainly because of the highway program), population density was positively related to State income, and these relationships alone were strong enough to produce a negative, zero-order correlation coefficient between grants and State income. With population density held constant, grants in 1959 showed a nonsignificant positive correlation with income (0.05). See "Federal Grants and the Income-Density Effect," *National Tax Journal*, vol. 15 (March 1962), pp. 105–108.

[16] For a recent attempt to measure the redistributional effects both of Federal grants themselves and of the taxes that finance them see James A. Maxwell, *Financing State and Local Governments* (The Brookings Institution, 1965), pp. 61–66.

urements of the interstate burdens imposed by the whole tax system have some highly arbitrary characteristics. All things considered, it seems best to concentrate, as is done in the rest of this section, on the redistributional powers of Federal grants taken by themselves alone.

Introducing explicit equalizing formulas into Federal grant programs is largely a postwar phenomenon (table IV–6). The use of these formulas appears to be increasing,[17] but in 1962 less than 19 percent of the $7 billion granted to State and local governments was distributed on the basis of formulas that either allocated a higher proportion of the available funds to low-income States or increased the Federal share of total program costs in States with low per capita income.[18] Moreover, as table IV–6 shows, public assistance programs were a major segment (73 percent) of the total equalization group, and under them measures of State fiscal capacity were used only in setting the matching requirements. To qualify for a larger share of Federal funds, therefore, low-income States had to put up money of their own. Under the grant programs listed in the top part of table IV–6, in contrast, equalization applied to the apportionment formulas so that low-income States automatically qualified for a higher portion of funds distributed. The superior equalizing power of the latter arrangement is indicated by the fact that while the correlation coefficient between equalized public assistance grants and State per capita income in 1962 was only −0.213, the correlation between the rest of the grants listed in table IV–6 and State income was −0.601.[19]

In general, Federal grant programs make use of three different kinds of equalization arrangements. The first is the Hill-Burton formula, which in its basic form defines the grant to be made to a given State as:

$$G_i = \frac{P_i A_i^2}{\Sigma P_i A_i^2} F; \qquad A_i = 100 - 50 \frac{Y_i}{Y}$$

where:

G_i = amount of grant to be made to the i-th State,
P_i = population in the i-th State,
A_i = allotment percentage for the i-th State,
Y_i = per capita personal income in the i-th State,
Y = per capita personal income in the United States.
F = total funds appropriated for distribution in a given year.[20]

In effect, Hill-Burton grants are distributed on the basis of weighted population, and the weights used increase rapidly as per capita State income declines. The extent of the variation in the weights may be

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[17] Statistical measures of the relation between grants and State per capita income confirm this trend. Haskell's net correlation coefficients (population density held constant), for example, declined from 0.24 in 1932, to 0.13 in 1952, and then to 0.05 in 1959 (*op. cit.*, p. 106).

James A. Maxwell obtained similar results from rank correlation analysis, his gross coefficients being 0.31 in 1940–41, —0.18 in 1951–52, and —0.59 in 1952–53. See his "The Equalizing Effect of Federal Grants," *Journal of Finance*, vol. 9 (May 1954), p. 209.

[18] Not only were equalization formulas used in programs that distributed only a small portion of total grant funds ($2.9 billion of the $7 billion total), but in many of these programs equalization applied only to part of the funds available (table IV–6).

[19] ACIR, *The Role of Equalization in Federal Grants*, p. 64.

[20] The grant amounts derived from this formula are frequently adjusted so that no State's allotment falls below a stated dollar minimum and the allotment percentages used do not fall outside a fixed range.

seen in the following tabulation, which covers approximately the range in State per capita income that currently prevails:

Y_i	A_i	A_i^2
$Y_i=1.4Y$	30	900
$Y_i=Y$	50	2,500
$Y_i=0.5Y$	75	5,625

TABLE IV–6.—*Federal grants-in-aid distributed on the basis of a fiscal capacity index, by program, 1962* [1]

Program	Year equalization provision introduced	Type of equalization provision [2]	Distributions based on fiscal capacity index	
			Amount (millions)	Percent of total funds distributed under program
Programs using fiscal capacity index in apportionment formula:				
Maternal and child health	1935	N/Y	$9	37
Crippled children's services	1935	N/Y	10	41
General health	1935	N/Y	14	95
Tuberculosis control	1944	N/Y	1	18
Mental health	1946	N/Y	2	30
Hospital and medical construction	1946	HB	61	100
School lunch	1946	N/Y	89	100
Cancer control	1948	N/Y	2	60
Heart disease control	1948	N/Y	3	63
Basic rehabilitation services	1954	HB	63	100
Water pollution control	1956	N/Y	3	58
Waste treatment works construction	1956	N/Y	19	46
Child welfare services	1958	HB	16	86
National Defense Education Act	1958	HB	45	70
Community health services	1961	N/Y	5	100
Total			339	80
Programs using fiscal capacity index in matching formula only:				
Library services in rural areas	1956	A	8	100
Water pollution control	1956	A	2	42
Old-age assistance	1958	F	538	44
Aid to dependent children	1958	F	213	26
Aid to the blind	1958	F	17	37
Aid to the disabled	1958	F	70	36
Child welfare services	1958	HB	3	14
Medical aid for the aged	1960	F	111	94
Total			962	39
All programs			1,301	46

[1] Excludes the disaster relief and special milk programs which allocated their funds, to a limited extent, according to State fiscal capacities.

[2] N/Y—allocation by indexes of program need and inversely by per capital income. HB—Hill-Burton formula. A—variable matching on the basis of the Hill-Burton allotment percentage. F—variable matching on the basis of the Federal percentage.

Source: ACIR, *The Role of Equalization in Federal Grants* (January 1964), p. 43.

According to calculations made by I. M. Labovitz, if $1 billion were to be distributed to the States by the Hill-Burton formula, using 1960 population data and average State per capita incomes in 1957–59, and giving no State less than $4 million, the highest-income State (Delaware) would receive only $238 per capita, while the lowest-income State (Mississippi) would receive $1,176 per capita.[21] Of the four Hill-

[21] *Federal Grants to States: Comparison of Selected Hypothetical Distribution Formulas and Matching Requirements,* Library of Congress, Legislative Reference Service (March 1961). In the computations no allotment percentage was allowed to exceed 75 percent or to fall below 33⅓ percent.

Burton programs listed in table IV–6, two use the basic formula and two replace total population with subgroups that are more closely related to the purpose of the grants.[22]

The second kind of equalization formula, used in 1962 for nine health-grant programs listed in table IV–6, is determined administratively within general statutory guidelines that specify allocation on the basis of program need and State fiscal capacity. There is, consequently, considerable diversity among the programs, as can be seen from the following greatly abbreviated tabulation based on 1963 laws:

Program	Percentage of funds allocated on the basis of P_i/Y_i	Other measures used as allocators
General health	95	Reciprocal of population density.
Community health	40	Population 65 and over, $1/Y_i$.
Tuberculosis control	20	Morbidity and mortality.
Cancer control	60	Mortality and reciprocal of population density.
Mental health	30	Total population.
Heart disease control	[1] 63	1st 100,000 of State population.
Water pollution control	67	Population density and the number of waste-producing business.
Radiological health control	35	Number of radiation sources, $1/Y_i$.
Crippled children's services	0	Population under 21 (double weight in rural areas) and State per capita income.
Maternal and child health services	0	Live births (double weight in rural areas) and State per capita income.

[1] In 1962.

It will be noted that under all programs a portion of the funds is distributed inversely in relation to State per capita income (Y_i). Matching provisions are typically on a 50–50 basis, and all but the first program guarantee the States a fixed minimum grant.[23] Two other programs listed in table IV–6 (school lunch and waste treatment works construction) also distribute their funds on the basis of program need and State per capita income, but the formulas used are set by statute rather than by administrative discretion.

The third type of equalization applies to public assistance grants and works so as to reduce matching requirements for low-income States that support program levels above a stated minimum. This is accomplished by defining a Federal percentage, F, so that

$$F = 100 - Y_i^2/Y^2 \text{ and } 50 \leq F \leq 65$$
$$\text{or } 50 \leq F' \leq 80,$$

and using F and F' in the second and third stages, respectively, of a three-stage grant formula:

A. Each State receives a fixed percentage of the first $\$x$ of its average monthly payment per assistance recipient.

B. Each State receives a variable percentage, F, of the next $\$y$ of its average monthly payment per assistance recipient. It will

[22] Child welfare grants are based on the population under 21 years of age, and NDEA grants for the acquisition of special school equipment use school-age population both for P_i and in the computation of Y_i.

[23] For further details see ACIR, *The Role of Equalization in Federal Grants*, pp. 159–163, 171–186, 192.

be noted that F (or F') is 50 percent for all States with average or above-average per capita income.

C. Every State receives an additional grant, under the old-age, blind, and disabled assistance programs, equal to the larger of:

(1) A fixed percentage of the first $\$m$ of payments made to vendors of medical or remedial care for the aged, blind, and disabled and

(2) A variable percentage, F', of the smaller of:

(a) total vendor payments for medical or remedial care, or

(b) the next $\$z$ of all average monthly payments per adult assistance recipient that exceed $\$x + \$y$.

It will be noted that the equalization provisions of stage C will apply only to States with below-average per capita income that make above-scale—that is, greater than $\$x + \$y$—average monthly assistance payments.[24]

Some equalization under the Kerr-Mills program, which assists the States to provide medical assistance for individuals aged 65 or over who do not receive old-age assistance but who are unable to meet the costs of necessary medical services, is also achieved by making the Federal grant equal to F' times the total amount spent by each State for such medical assistance. This meant that in 1962, for example, West Virginia was able to spend $6.1 million at a cost to itself of only $2 million, whereas all of the States with above-average per capita income had to match Federal funds equally. Apart from West Virginia, however, the 10 lowest-income States participated so little in the program that their average per capita grant for medical assistance to the aged was only 37 cents in 1962, compared to an average grant of 84 cents per capita in the ten highest-income States.[25]

Given the variety of equalization formulas used in 1962 and their uneven application to different programs, it is not surprising to find that a classification of Federal grants by broad program groups produces few areas in which average per capita grants are systematically related to State per capita income. When the States are divided into quintiles[26] on the basis of per capita personal income (table IV–7), for example, neither health grants nor grants for assistance to low-income families show any pronounced tendency to rise as average State income falls until the two lowest quintiles are reached. Grants for federally affected schools and for transportation, neither of which are distributed on an equalization basis, exhibit remarkably similar patterns, rising steadily in average amount from the first to the fourth quintile and then dropping abruptly when the group of lowest-income States is reached. Urban development grants, as would be expected, are concentrated in the wealthiest States, except for the lowest quintile which outranks the middle-income States by a wide margin.

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[24] For further details see *Catalog of Federal Aids to State and Local Governments*, prepared by the Legislative Reference Service of the Library of Congress for the Senate Committee on Government Operations, 88th Cong., second sess. (1964), pp. 85–98. In 1963, $x = \$35$ for aid to the aged, blind, and disabled and $17 for aid to dependent children; $y = \$35$ for the first three programs and $13 for the last; and $m = \$15 = z$.

[25] See ACIR, *The Role of Equalization in Federal Grants*, p. 158.

[26] Alaska was omitted because its geographical characteristics make it a special case.

TABLE IV-7.—*Federal grant-in-aid expenditures in 1962, by selected program group:*[1] *Average per capita amounts for States by quintiles based on State per capita personal income*[2]

Quintile	Program group						
	Education		Low income assistance	Health	Transportation	Resource development	
	Federally affected schools	Other				Urban	Other
Highest	$1.77	$1.35	$11.10	$0.93	$17.30	$3.25	$1.15
2	2.14	1.75	11.68	.84	20.60	2.10	1.37
3	2.32	1.92	12.04	.88	22.50	.70	1.45
4	2.78	2.42	15.66	1.24	27.30	.48	1.96
Lowest	.95	2.54	19.46	1.62	15.30	1.57	1.79

[1] With the exceptions noted below the program groupings are the same as those used in chap. III, tables III-3 through III-7. Since the emphasis here is on equalization rather than on benefit spillovers, a few of the multipurpose programs have been reclassified: low-rent public housing being moved from low-income assistance to urban resource development; grants for crippled children, maternal and child health, and child welfare being shifted from health to low-income assistance; and the school lunch and special milk programs being shifted from health to nonurban resource development. Finally, grants-in-kind, such as those made under the food stamp and surplus agricultural commodity programs, have been omitted.

[2] Quintiles are based on 1962 per capita income, but the State rankings are exactly the same as those given in table IV-3.

Source: Computed from data on per capital grants given in ACIR, the *Role of Equalization in Federal Grants* (January 1964), pp. 110ff.

Though they have been increasingly exploited in this country in recent years, the equalization powers of functional Federal grants are strictly limited. Basically, the reason is that the grants themselves have a restricted role to play in the Federal fiscal system—namely, to raise interpersonal equity and increase economic efficiency by paying for the external benefits generated by the spending programs of State and local governments. Properly used, therefore, functional grants cannot help to equalize the abilities of those governments to support activities of purely local interest. To employ them for that purpose would be to interfere unjustifiably with State and local prerogatives to manage their own fiscal affairs. When equalization is the goal, it is unconditional grants-in-aid that should be the center of attention.

THE DISTRIBUTIONAL EFFECTS OF UNCONDITIONAL FEDERAL GRANTS-IN-AID

The specific function of unconditional Federal grants-in-aid would be to increase the income of all State and local governments, and to do so by favoring those with relatively high ratios of needs to resources. As noted earlier, these ratios can be defined with varying degrees of complexity. At our present stage of discussion, however, there is much to be said for simplicity. Economic analysis has yet to produce the ideal measures of fiscal capacity and of basic public needs, and new governmental programs are difficult enough to evaluate even when presented in their simplest feasible form. Allocation formulas must also, of course, be based on data that are obtainable at regular intervals, perhaps annually, at reasonable cost to the government. In this section six specific formulas, each meeting the twin tests of simplicity

and availability, will be used to show the wide variety of distributional effects that could be generated by means of Federal balancing grants.

The calculations presented below are based on the assumption that $1 billion is to be distributed unconditionally to the States. This sum was selected because it is large enough to make some difference and because the individual State shares derived from it can readily be adjusted to show the effects of larger or smaller grant programs. The six allocators to be considered are:

1. Federal individual income tax collections in 1962 (the latest available year). This was chosen to show the effects of a tax-sharing arrangement that returned income tax revenues to the jurisdictions of source.

2. State personal income in 1963. By itself, a set of proportional grants would be distributionally neutral, though if they were financed by a progressive tax, the entire program would have an equalizing effect. That effect, however, should be attributed to the tax and not to the grants, and the latter are included here as a benchmark series that involves no interstate redistribution of personal income.

3. Population in mid-1963. This is the simplest and most readily available measure of the general need for public services.

4. Population weighted by the reciprocal of State per capita personal income in 1965—$P_i \cdot Y/Y_i$, in terms of the symbols used earlier in the chapter. This formula, now used in several functional grant programs, gives greater assistance to low-income States than straight per capita grants.

5. Population weighted by the reciprocal of per capita income and by an index of State and local tax effort—$P_i \cdot Y/Y_i \cdot E_i/E$, *where* $E_i = T_i/Y_iP_i$ is the ratio of tax collections to total personal income in the i-th State, and $E = T/YP$ is a similar measure for the country as a whole. The addition of tax effort to the allocation is primarily intended to minimize the danger that unconditional Federal grants would be used by some of their recipients to shift legitimate fiscal responsibilities onto others. In addition, it would have the presumably unobjectionable effect of favoring States whose residents have a relatively strong liking for public services. The series used for this purpose is one of several developed from 1959–60 data by the ACIR.[27] All of these series will be discussed below.

6. The Hill-Burton formula—$P_iA_i^2$, where $A_i = 100 - 50Y_iY$—using computations made by I. M. Labovitz from 1957–60 data.[28] Like the fourth allocator, this formula is in current use (see table IV–6) and gives relatively large amounts of assistance to the low-income States.

These six allocation formulas will now be used to illustrate the broad variations in distributional effects that could be achieved with a $1 billion program of unconditional Federal grants-in-aid.[29] Though perfectly adequate for this purpose, the allocators do use data from slightly different periods of time and hence do not show the precise

[27] *Measures of State and Local Fiscal Capacity and Tax Effort*, Ch. 5. Readers may obtain a rough picture of the differences among the Commission's measures of tax effort by comparing the last column of table IV–4 with each of the preceding four columns. See also app. table A–6.

[28] *Op. cit.*

[29] The basic data needed for each of the allocators are given in app. table A–1.

results that would be produced by a perfectly homogeneous set of formulas.

TABLE IV–8.—*Distribution of unconditional Federal grants, allocated by 6 alternative methods, among quintiles of States*

[Percent distributions]

Quintile	Grant allocator					
	Federal individual income taxes, 1962 (1)	State personal income, 1963 (2)	Mid-1963 population (3)	$P_i \cdot \frac{Y}{Y_i}$ (4)	$P_i \cdot \frac{Y}{Y_i} \cdot \frac{E_i}{E}$ (5)	Hill-Burton [1] (6)
Highest [2]	45	42	35	27	28	21
2	25	25	24	23	21	22
3	9	10	11	11	12	12
4	11	12	14	17	16	17
Lowest	9	12	16	22	23	28

[1] The allotment percentage, A_i, was kept within the limits of 33⅓ and 75 percent, and no State received less than ⅒ percent of the total sum to be distributed.
[2] Includes Alaska whose maximum share was ¹⁄₁₆ percent under the Hill-Burton formula. All other shares were under ³⁄₁₆ percent.

Source: App. table A–2.

To highlight the potential equalization and fiscal effects of Federal balancing grants, the 50 States and the District of Columbia have been divided into quintiles based on their 1963 per capita personal income.[30] Table IV–8 then shows the proportion of grants that would be received by each group of States under each of the six distribution formulas. As expected, Hill-Burton grants would be the most equalizing, providing 28 percent of all funds distributed to the bottom quintile of States, compared to 16 percent for straight per capita grants and only 9 percent for a return-to-the-source sharing of the Federal individual income tax. Comparing the fourth and fifth columns of the table, one may note that the addition of a tax effort index has little effect on the distribution of grants among the five groups, though, as will be seen later, some States would experience significant changes in their individual shares. Column (2) shows both the allocation pattern of a set of proportional grants and the degree to which personal income is distributed unequally among the States. Federal individual income taxes, of course, are even more unequally distributed.

In 1963 a new $1 billion program of Federal grants would have been equivalent to a 2.25 percent increase in the tax receipts of all State and local governments and would have financed a 1.75 percent increase in all of the direct general expenditures that they paid for from their own funds.[31] These percentages, of course, would have varied considerably from one group of States to another, depending upon the method used to allocate the $1 billion among them. As

[30] See table IV–3. The first quintile contains 10 States and the District of Columbia. Since Alaska, which also falls in the first quintile, has some very special characteristics, it is either excluded entirely or included but shown separately.

[31] In 1963 total State and local taxes were $44.3 billion, total direct general expenditures were $64.8 billion, and intergovernmental revenue received from the Federal Government was $8.7 billion. State and local expenditures from their own funds, therefore, were $56.1 billion. See U.S. Bureau of the Census, *Governmental Finances in 1963* (November 1964), pp. 31 and 34.

table IV–9 shows, tax sharing would have financed a 2.1 percent increase in State-local "own" expenditures for the top quintile of States but only a 1.4 rise for the bottom quintile. A per capita distribution weighed by both income and tax effort would have paid for only a 1.2 percent increase in spending by the highest-income group and for more than a 3.5 percent increase by the lowest quintile. The redistributive effects of the four allocators used in table IV–9 may be seen by comparing the grant distributions they produce, relative to State personal income (given in the top row of figures for each allocator), with the flat 0.22 percent of personal income which a $1 billion set of proportional grants would provide in each State. By this standard, tax sharing would be mildly regressive, a straight per capita allocation would have important equalizing effects, and these effects could be increased by the addition of weights based inversely on State per capita income. Once again, use of the tax effort index would not affect the quintile averages materially.

No program of Federal grants-in-aid can be evaluated without careful attention to its effect on individual States. Full details for the six allocators already discussed are given in appendix tables A–2 to A–5, but table IV–10 presents a condensation of these results for a selected group of States. While some States, such as Colorado and Oregon, would not be much affected by the choice of distribution formula (at least among those shown in table IV–10), others would clearly have much larger grants under some programs than under others. Perhaps the most striking contrast is between Delaware and Mississippi, each of which would receive $4 million if the $1 billion total were distributed on the basis of Federal individual income tax revenues. Because Delaware is a high-income, low-effort State, however, it would receive little more than $1 million under the fourth allocator, whereas low-income, high-effort Mississippi would receive

TABLE IV–9.—*Summary of 4 alternative methods of distributing 1,000,000,000 among the States*

Allocators and grant ratios	Quintile averages [1]				
	Highest	2	3	4	Lowest
Distribution by Federal income tax receipts: Average percent of grant to—					
1. Personal income	0.24	0.21	0.19	0.18	0.17
2. State-local taxes	2.66	2.29	1.86	1.81	1.91
3. State-local "own" expenditures [2]	2.13	1.78	1.45	1.36	1.39
Per capita distribution: Average percent of grant to—					
1. Personal income	.18	.22	.24	.27	.31
2. State-local taxes	1.95	2.30	2.23	2.65	3.33
3. State-local "own" expenditures [2]	1.57	1.79	1.74	1.99	2.52
Per capita with income (Y/Y_i) weight: Average percent of grant to—					
1. Personal income	.14	.20	.24	.31	.44
2. State-local taxes	1.51	2.17	2.32	3.11	4.66
3. State-local "own" expenditures [2]	1.22	1.69	1.81	2.33	3.51
Per capita with income (Y/Y_i) and tax effort (E_i/E) weights: Average percent of grant to—					
1. Personal income	.13	.21	.27	.35	.46
2. State-local taxes	1.39	2.16	2.59	3.45	4.72
3. State-local "own" expenditures [2]	1.19	1.67	2.02	2.60	3.56

[1] Alaska excluded. The State-local tax and expenditures series are for 1963.
[2] Total State-local expenditures minus intergovernmental revenue received from Federal Government.

Source: Appendix tables A-3, A-4, and A-5.

TABLE IV-10.—*Grant amounts allocated to selected States by 5 alternative methods of distributing $1,000,000,000*

[In millions of dollars]

State [1]	Federal income taxes (1)	Population (2)	Population weighted by per capita income (3)	Population weighted by per capita income and tax effort (4)	Hill-Burton formula [2] (5)
A. Massachusetts (9)	$32.8	$27.7	$22.8	$23.5	$20.6
B. New York (5)	127.1	93.8	73.5	83.1	50.0
New Jersey (8)	44.6	34.3	27.8	23.6	20.1
Delaware (3)	4.0	2.5	1.8	1.3	[2] 4.0
Maryland (11)	21.3	17.4	14.8	13.6	13.9
C. Illinois (7)	72.7	54.0	43.1	36.6	32.5
Indiana (18)	24.4	24.9	23.6	21.7	25.7
Wisconsin (23)	19.7	21.5	21.3	23.0	22.2
D. Minnesota (24)	15.6	18.6	18.7	22.3	21.1
Missouri (14)	21.6	22.9	21.5	16.1	24.3
South Dakota (40)	2.1	3.9	4.8	6.7	5.6
E. Virginia (34)	17.9	23.0	26.1	21.4	28.3
Tennessee (46)	13.5	19.6	25.9	24.6	32.4
Alabama (48)	9.6	17.7	25.2	22.9	31.5
Mississippi (51)	4.2	12.1	20.8	25.0	25.6
F. Colorado (22)	10.0	10.4	10.2	11.6	9.9
California (6)	116.2	93.2	73.5	83.8	52.0
Oregon (13)	9.2	9.7	9.0	10.2	9.8

[1] Grouped geographically. Numbers in parentheses are the 1963 rankings by per capita income (high to low).

[2] The allotment percentage, A_i, is kept within the limits of 33⅓ percent and 75 percent, and no State receives less than $4,000,000.

Source: App. table A-2.

$25 million. Among the States that would be significantly affected by the use of a tax effort index are California, New York, South Dakota, and Wisconsin, all of which would gain, and Illinois, Missouri, New Jersey, and Virginia, all of which would lose. It is important, therefore, to consider the basic determinants of tax effort and the problems involved in using some measure of its as one of the allocators of unconditional intergovernmental grants.

The degree of tax effort that is made in different jurisdictions is clearly a function of both fiscal capacity and the need for public services. Of two States with equal needs, the wealthier will have to strain less to meet them, and of two States with equal incomes, the one with greater needs will be able to satisfy them only by greater fiscal efforts. In addition, a strong taste for public goods will, other things being equal, make for a higher tax effort, and vice versa. The Advisory Commission's indexes of tax effort all relate actual State and local tax collections in 1960 to its basic 1959-60 need-capacity measures—per capita personal income, per capita above-minimum family income, per capita income produced, and the per capita yield of the representative tax system. Since these four measures, as noted earlier, differ significantly among themselves, the tax effort indexes derived from them behave in a similar fashion. Some States, therefore, cannot be classified by tax effort unless one is willing to make a choice among the alternative indexes. This same difficulty, of course, must be faced if grants are to be allocated inversely by State fiscal capacities, and if personal income is selected for this purpose, it should also be used in any tax effort index that is to be added to the grant allocation formula.

There does not appear to be any strong, systematic relationship between tax effort and State per capita income levels, though a definitive answer to this question must await a multivariate, statistical analysis of all of the determinants of tax effort.[32] In the meantime, table IV–11 shows that while some high-income States show high tax effort (New York, California, and Massachusetts), others exert relatively low efforts (Delaware, Connecticut, Illinois, and New Jersey). A similar contrast prevails among the low-income States: Louisiana and Mississippi are in the high-effort category, and Kentucky, Tennessee, Alabama, and Arkansas are in the low-effort class. Table IV–11 also shows that of the seven high-income States making a below-average effort according to the personal income index, only Illinois fails to show a significantly higher effort by the representative tax system test. This suggests that the base of the representative system rises less than proportionately to income as income rises. Furthermore, it suggests that States are reluctant to push their own tax rates much above those prevailing elsewhere, with the result that affluent States often fail to exploit their full fiscal capacities. If these suggestions are true, the economic and political measures of tax capacity, and therefore of actual tax effort, will diverge, and the policymaker may feel obliged to adopt some compromise between them as an allocator of Federal grants.

Another aspect of the tax effort index that is chosen is the frequency with which its values will be changed as time passes. If this is to be done annually, and there is much to be said for keeping the index as current as possible, some readily available base such as State personal income will be preferable to measures such as the representative tax system which are more difficult to construct. The very decision to keep the tax effort index up-to-date will, of course, affect the interstate distribution of grants, since some states at least can be expected to react by exerting more tax effort in order to qualify for additional Federal money. While the first year's allocation of $1 billion might, for example, be that shown in column (4) of table IV–10, in subsequent years the low-effort States might well succeed in increasing their shares.

Finally, it should be stressed again that all existing tax effort indexes are but crude approximations of ideal measures. Before ideal measures can be derived, however, much more will need to be discovered about such things as: the effects of urbanization on fiscal capacities and fiscal needs; the extent to which user charges, fees, and licenses should be incorporated into measures of fiscal effort; the extent to which such measures are distorted by tourism unless adjustments are made for taxes thought to be borne by vacationers rather than local residents; and the extent of the adjustments needed for interstate differences in the prices of public services of the same quality.

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[32] Among the variables that it would be interesting to include in such a study would be Federal grants-in-aid, which by lowering needs for public services might tend to lower State tax efforts, and a measure of the extent to which different States rely on "exportable" taxes. If legislators and voters really believe that such taxes can be shifted largely to outsiders, States making extensive use of them should, other things equal, show high degrees of tax effort. By way of intriguing possibilities—of the three States that made extensive use in 1962 of severance taxes, which are presumably among the most "exportable" of taxes, Louisiana was a high tax-effort State, Texas was a low-effort State, and New Mexico was about average. For the tax effort indexes of these States see app. table A–6.

TABLE IV-11.—*Tax effort indexes for the top and bottom quintiles of States, ranked by 1963 per capita personal income*

	Tax effort indexes ($E_i E$) based on—	
	Personal income	Representative tax system
Top quintile:		
District of Columbia	79	85
Nevada	109	93
Delaware	73	87
Connecticut	82	94
New York	113	136
California	114	109
Illinois	85	88
New Jersey	85	97
Massachusetts	103	121
Alaska	71	116
Maryland	92	106
Bottom quintile:		
West Virginia	97	101
Georgia	97	102
North Carolina	99	96
Kentucky	83	80
Tennessee	95	93
Louisiana	126	106
Alabama	91	91
Arkansas	100	90
South Carolina	103	106
Mississippi	120	113

E_i=(1960 State and local tax collections in the i-th State)÷(1959 personal income or 1960 yield of the representative tax system in the i-th State). E=similar ratios for the country as a whole.

Source: Appendix table A-6.

This section has dealt with some of the simpler allocation formulas that might be used to distribute a given sum of money among the States in the form of unconditional Federal grants. Even on this restricted basis, however, a wide range of distributional effects could be generated. Still different results could be achieved in various ways—by applying different weights to the factors discussed above; by working with a broader, and more complex, set of fiscal measures; or by segregating part of the total funds to be distributed and allocating this part entirely to the lowest income States. Joseph A. Pechman, for example, has noted that, "Even if as little as 10 percent of the total were divided among the poorest third of the States (say, in proportion to population weighted by the reciprocal of per capita personal income), the grant to the poorest State would be almost double the amount it would obtain on a straight per capita basis."[33] Federal balancing grants, it is clear, could achieve whatever pattern of distributional effects is desired, and moreover, they could do this by the use of relatively simple and efficient apportionment formulas.

THE ALLOCATIONAL EFFECTS OF UNCONDITIONAL FEDERAL GRANTS-IN-AID

The changes in the allocation of resources that a program of unconditional Federal grants would bring about are extremely difficult to specify, except in the broadest terms. They constitute, therefore, a highly controversial aspect of the whole problem, and one on which

[33] "Financing State and Local Government," *op. cit.*, p. 82.

the critics of unconditional Federal grants have concentrated their attention. Among the questions that they have asked, and that will be discussed in this section, are the following:

Will the States spend the money wisely and efficiently for the right programs?

Will local governments, particularly those in urban areas, receive a large enough share of the funds?

Will the States use the grants to expand expenditures rather than to hold tax rates below levels that otherwise would have prevailed?

Will the grants impede or accelerate the movement of workers from resource-poor areas to regions where suitable employment opportunities are available or can be developed?

TABLE IV-12.—*State and local direct general expenditures, by major function, fiscal years 1953 and 1963* [1]

[Dollar amounts in billions]

Function	Amount		Increases, 1953-63		
	1953	1963	Amount	Percent distribution	Percent increase
Total, general expenditures	$27.9	$64.8	$36.9	100	132
Education	9.4	24.0	14.6	40	156
Local schools	7.8	18.8	11.0	30	141
Higher education	1.4	4.7	3.3	9	246
Other	.2	.5	.3	1	150
Highways	5.0	11.1	6.1	17	123
Public welfare	2.9	5.5	2.6	7	88
Functional cash assistance	2.2	3.4	1.2	3	57
Other	.8	2.1	1.3	4	179
Health and hospitals	2.3	4.7	2.4	6	104
Police and fire	1.6	3.5	1.8	5	112
Sewerage and sanitation	.9	2.2	1.3	3	141
Natural resources	.7	1.6	.9	2	125
Housing and urban renewal	.6	1.2	.6	2	98
General control and financial administration	1.3	2.5	1.2	3	96
Interest on general debt	.6	2.2	1.6	4	258
Other	2.6	6.3	3.8	10	147

[1] Excludes insurance trust, liquor store, and public utility expenditures. Includes Federal grants-in-aid.

Sources: U.S. Bureau of the Census, *Governmental Finances in 1963* (November 1964), and *Historical Statistics on Governmental Finances and Employment, Census of Governments*, 1962, vol. VI, No. 4.

THE STRUCTURE OF STATE AND LOCAL SPENDING

No one, so far as I know, has yet developed a reliable method of predicting how legislators and administrators, when presented with a certain sum of money, would allocate the proceeds among different government programs. And, all things considered, perhaps this is just as well. Lacking such a forecasting model, one must turn to past actions as the best available guide to future behavior. Between 1953 and 1963, as shown in table IV-12, State and local governments devoted 40 percent of the decade's increase in general expenditures to education, 17 percent to highways, 7 percent to public welfare, 6 percent to health

and hospitals, and the rest to a long list of less costly functions. Among the most rapidly growing areas were higher education, interest on general debt, and public welfare expenditures not assisted by functional Federal grants. Support for local schools did outpace State and local expenditures in general, but not by much. Nevertheless, one may infer from these data that a major share of any unconditional Federal grants made to the States would be spent on education.

Of course, each State is likely to react differently, and that very diversity is one of the strongest arguments in favor of assisting States, insofar as they need help with their internal fiscal affairs, by means of unconditional grants. Table IV-13 illustrates this point of the group of States selected for special attention in this study. For each of the five categories of general expenditure shown, 1957-62 increases in spending varied considerably in relative importance from one State to another. Increased spending on local schools, for example, accounted for 44 percent of the total rise in spending in Massachusetts but for only 22 percent in Tennessee; health and hospitals attracted 9.5 percent of the 1957-62 expenditure rise in Mississippi, compared to 4 percent in Virginia and Wisconsin. If some of the increases shown are considered to be too small in terms of the national welfare, the appropriate solution would be an expansion in functional Federal grants-in-aid. Once benefit spillovers have been taken care of in this fashion, however, there is much to be said for allowing each State to determine its own mix of public services.

TABLE IV-13.—*Increases in State and local general expenditures, by major function, selected States, 1957-62*

State [1]	Percent of 1957-62 increase in total general expenditures devoted to—					Amount of increase in total general expenditures (millions)
	Local schools	Higher education	Highways	Public welfare	Health and hospitals	
A. Massachusetts	44.0	5.0	-12.0	13.0	5.0	$377
B. New York	27.0	5.0	13.0	8.0	7.0	2,228
New Jersey	35.0	8.0	8.0	7.0	5.0	637
Maryland	40.0	8.0	0	7.0	8.0	332
C. Illinois	31.0	8.5	8.5	11.0	5.0	1,059
Indiana	43.0	12.0	13.5	3.0	6.0	451
Wisconsin	31.0	10.0	19.0	7.0	4.0	494
D. Missouri	33.0	7.0	21.0	6.0	8.0	355
E. Virginia	32.0	8.0	19.0	7.0	4.0	380
Tennessee	22.0	6.0	29.0	5.0	6.0	331
Mississippi	26.0	12.0	16.0	9.5	9.5	243
F. Colorado	37.5	16.5	3.0	10.0	9.0	216
California	28.0	14.0	9.5	8.0	6.0	2,964
Oregon	29.0	12.0	13.0	6.5	6.5	228

[1] Grouped geographically.

Source: U.S. Bureau of the Census, *Historical Statistics on Governmental Finances and Employment, Census of Governments*, 1962, vol. VI, No. 4.

THE PRINCIPLE OF FINANCIAL RESPONSIBILITY AND GOVERNMENTAL EFFICIENCY

A common criticism of unconditional grants is that they infringe the principle of financial responsibility which asserts that public funds will be well spent only when they are raised and spent by the same governmental unit. The argument is that voters will scrutinize the use of

public funds more carefully when they themselves provide them than when the money comes from outsiders. From this it follows that any set of fiscal gifts will increase, at least to some extent, waste and inefficiency in governmental operations.

In the categorical form just stated, the principle of financial responsibility must be rejected, Although unconditional grants may engender carelessness in an affluent recipient, or in almost anyone if they are made in very generous proportions, under different circumstances they are likely to have exactly the opposite effect. A government that is forever feverishly seeking funds with which to meet its next payroll will have little time, and less inclination, for effective fiscal planning. Under such conditions, problems will typically be met on an ad hoc basis, with much waste in the process. With some unconditional grants in hand, however, the government would be free to lift its eyes from its immediate concerns and to plan how best to meet its future responsibilities.

Even governments that are better off financially cannot deal effectively with the complex problems of the modern world without administrators and programers who are highly trained and strongly motivated. To obtain such people State and local governments must have not only the money to pay their salaries but also enough general resources to support a broad range of important public programs. Opinions differ as to how many States, if any, have already reached this level of fiscal affluence, but until most of them do, many talented people are likely to find Washington a more exciting place to work than the State capitals. This drift of brain-power to the Federal level of government cannot be lessened by an expansion of functional Federal grants-in-aid but it might be by a new program of unconditional grants or some other form of intergovernmental fiscal assistance that leaves most of the initiative for spending decisions in State and local hands.

Fiscal efficiency requires both that State and local governments be able to afford the very best and that they care enough to use it effectively when they have it. Unconditional grants are one important way of dealing with the first problem, and if they do not become too large compared to local revenues, they should not involve any serious sacrifice of incentives toward efficiency. The most critical stage, presumably, would occur at the very beginning, when a new program of unconditional grants—even of fairly modest dimensions—would constitute a significant portion of the additional revenues accruing automatically to State and local governments. Between 1962 and 1963, for example, general revenues to State and local governments from their own sources increased by $3.8 billion, and of this amount perhaps $2.5 billion resulted directly from the growth in GNP during that period.[34] If these revenues are projected to 1966 at the same annual rate of growth (7.5 percent), a level of $67 billion is obtained, implying a built-in 1966–67 rise of some $3.3 billion. If a $1 billion program of

[34] "General revenue from own sources," as the term is used by the Bureau of the Census, includes taxes, fees, charges, and miscellaneous receipts but excludes both intergovernmental revenue from the Federal Government and revenue from utilities, liquor stores, and insurance trust funds. Between 1962 and 1963 it rose from $50.4 to $54.2 billion. See U.S. Bureau of the Census, *Governmental Finances in 1963*, p. 20. The $2.5 billion estimate in the text was made by assuming a built-in GNP elasticity of unity, so that general revenues from State and local sources should rise by approximately 5 percent a year.

unconditional Federal grants were started at this point, it would represent nearly a third of the additional revenues that State and local governments could expect to enjoy without having to raise tax rates. Depending upon the allocation formula used, the low-income States would enjoy an even greater jump in their available funds (see table IV-9).

Though an initial fiscal effect of this size may seem impressive, its threat to State and local financial responsibility is minimized by the shortness of its duration. Once the $1 billion program was in full operation, it would constitute a very small proportion of total State and local general revenues from their own sources (1.5 percent in 1966). Moreover, if the grants were made a fixed proportion of the Federal individual income tax base—a possibility that will be discussed in the next section—their built-in annual increase of approximately $70 million would be slightly over 2 percent of the built-in increase in State-local "own" general revenues.[35]

The size of this relative effect could presumably be increased substantially without endangering State and local financial responsibility. If some concern is felt over this problem, particularly at the beginning of the program, the first year's grant might be made contingent upon the approval—by an appropriate Federal or joint State-Federal body—of each State's budget, including the dispositions planned for both the new unconditional Federal grants and all other general funds available.[36] Thereafter, when the grant program would be a much less important element in State and local fiscal planning, there might simply be a periodic review by the same body of past State and local expenditures. A similar proposal, made recently by Joseph A. Pechman, would require "the Governors to file statements showing the plan for the use of the funds in detail. As guidance for the development of such plans, the Congress might indicate the general areas which it regarded as most urgent, including the need for making funds available for local government services. To be sure that the plan represented a broad spectrum of opinion in the State, the Governor might be directed to consult with local officials and representatives of citizens organizations before incorporating the plan in his budget. A detailed audited report on the actual use of the funds might also be required, as well as a certification by appropriate State and local officials that all applicable Federal laws, such as the Civil Rights Act, have been complied with in the State and local activities financed by these grants." [37]

Such controls do, of course, have their objectionable features. An alternative procedure would be to introduce the new Federal program in gradual stages so as to give all competing State-local political groups full opportunity to make their wishes known. In this way, perhaps with the assistance of Federal technical experts, alternative

[35] Based on the assumption that the Federal individual income tax base will be $260 billion in 1966 and that it will then be increasing at about $18 billion a year. (See the discussion in the next section.) If begun in 1966, therefore, the grants could be set at 0.4 percent of the Federal tax base.

[36] Plans for the unconditional grants alone would be meaningless because of the intermingling of money from different sources in the general fund.

[37] *Op. cit.*, pp. 83–84.

expenditure patterns would be debated and weighed, and hopefully one chosen that would best reflect local tastes and public needs.

THE URBAN-RURAL ALLOCATION OF GRANT FUNDS

Conditioned by an ingrained belief in the traditional rural bias of State legislatures, many city officials may hesitate to support unconditional Federal grants and may advocate instead the expansion of direct Federal aid to urban areas. Unless such aid is justifiable by benefit spillovers that extend beyond State lines, however, it weakens the Federal system because it bypasses the proper political lines of authority. The solution, which now appears much more attainable than it did only a few years ago, is to reapportion those State legislatures in which urban voters have been seriously underrepresented. Such reforms should broaden the appeal of unconditional Federal grants and make them one of the important ways of alleviating, through intergovernmental aid, the difficult fiscal problems of metropolitan areas.

THE BUDGETARY EFFECTS OF UNCONDITIONAL GRANTS

The basic rationale for balancing grants-in-aid implies that the wealthiest recipients would use them only to expand their expenditures and that some of the poorer grantees, having previously pushed their tax rates to excessively high levels in an attempt to maintain quite ordinary levels of public service, might choose to use some of the money to lower those rates, or at least to stabilize them. Since no State is made up exclusively of affluent areas, some substitution of Federal unconditional grant funds for State and local tax receipts could well occur in each of them. How important this type of budgetary effect might be is a matter for conjecture and debate, since past experience provides little or no basis for forecasting future behavior. Something is known, to be sure, about the effects on per capita State and local expenditures of existing Federal and State grant programs,[38] but all of these grants differ in important ways from unconditional Federal grants. The closest match is provided by the unrestricted State grants, but they are a small minority among State grant programs and, unlike Federal grants they cannot add to State fiscal capacities.

Paradoxically, one can say more about the probable composition than the magnitude of any reduction in State and local tax burdens brought about by unconditional Federal grants. The following tabulation shows that in recent years property and sales taxes have been the principal source of additional State-local tax revenue; therefore, it is reasonable to suppose that the tax-reducing effects of Federal unrestricted grants would be concentrated on them.[39]

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[38] The effects of State grants-in-aid are discussed in ch. III. Similar estimates have been derived for Federal grants, but their significance is more difficult to determine because many Federal grants are extended only on a matching basis. See the discussion of this question by Glenn W. Fisher, "Interstate Variation in State and Local Government Expenditure." *National Tax Journal*, vol. 17 (March 1964), pp. 71–72.

[39] U.S. Bureau of the Census, *Governmental Finances in 1963–64* (May 1965), and *Census of Governments: 1962*, vol. VI, No. 4, *Historical Statistics on Governmental Finances and Employment.*

Composition of recent increases in State and local tax revenues

Tax	Percent increase in total tax revenue	
	1953–63	1961–64
Property	46.0	36
Sales and gross receipts	32.0	37
Individual income	9.5	16
Corporate income	2.5	5
All taxes	100.0	100

Opponents of property and sales taxes are more likely to favor a new program of balancing grants than those who regard sales and property taxes as perfectly acceptable components of the fiscal system. In any case, it is important to note that the grants will undoubtedly not shift as many resources from the private to the public sector of the economy as the amounts of money tied up in the program would indicate.

REGIONAL RESOURCE ALLOCATION IN THE PRIVATE SECTOR

One of the liveliest debates in fiscal economics took place a few years ago over the question of whether equalization grants distorted or improved the allocation of resources among different parts of the country.[40] The answer, as with most questions worthy of debate, is that it all depends upon the circumstances. In this case the relevant circumstances are:

1. The factors accounting for the poverty of certain sections of the country and, in particular, whether or not a significant outmigration of labor is the best solution to the problem;
2. The extent to which economic adversity can be counted on to induce the kinds of outmigration from depressed areas that will help allocate workers to their most productive occupations; and
3. The uses to which the grant funds are put, and in particular whether these uses raise or lower the interregional mobility of labor.

The following paragraphs will discuss each point in turn.

The extent to which regional poverty can be alleviated by the movement of labor out of the area depends, essentially, on the quality of its basic endowments. Opponents of equalization grants are usually skeptical of finding many well-endowed, low-income areas where labor is not in excess supply compared to potential future demand for its services. Admittedly, lack of natural resources is a sufficient cause of poor regional economic prospects. It is not, however, a necessary one. Both technological change and population growth alter the value of different kinds of natural resources, and a given area may be poor because it has not had an opportunity to exploit its newly acquired eco-

[40] James M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review*, vol. 40 (September 1950), pp. 583–599; A. D. Scott, "A Note on Grants in Federal Countries," *Economica*, vol. 17 (November 1950), pp. 416–422; James M. Buchanan, "Federal Grants and Resource Allocation," *Journal of Political Economy*, vol. 60 (June 1952), pp. 208–217, followed by further comments by Scott and Buchanan in the same journal (December 1952), pp. 534–538.

nomic advantages. In addition, there is the well-known tendency for poverty, once it has taken a firm hold on a community, to perpetuate and accentuate itself quite independently of underlying economic potential. A recent study of geographic mobility, made for the Area Redevelopment Administration by the Survey Research Center of the University of Michigan, concluded that "depressed areas tend to lose through outmigration the more productive groups in the labor force: the young, the better educated, the businessman and the professional. The areas retain a disproportionate number of older people, those who have only a grammar school education, those not in the labor force, and blue-collar workers." [41] Finally, high population densities impose some important social costs that will be discussed in the next chapter. When these aspects are taken into account, the movement of people from thinly populated stagnating areas to thickly populated booming ones will frequently appear much less attractive than simple comparisons of per capita private income would indicate. The war against regional poverty, in short, must employ a wide variety of labor force policies. Some depressed areas need mainly to gain skilled and educated workers; some need a combination of inmovements and outmovements of different kinds of labor; and some need to accelerate outward movements already underway.

TABLE IV–14.—*Migration patterns and unemployment levels, 1955–60 and 1957–62*

MIGRATION IN 1955-60 OF EMPLOYED MEN 14 YEARS OLD AND OVER

Group	Percent of 1960 employment	
	10 areas [1] of high unemployment	10 areas [1] of low unemployment
Out-migrants	9.0	11.6
In-migrants	6.5	15.8
Net migrants	−2.5	4.3

OUT-MIGRATION IN 1957-62 BY UNEMPLOYMENT LEVEL OF COUNTIES OF ORIGIN

Unemployment group	Percent moving out
Little or no unemployment, 1955–62	19
Substantial unemployment for less than 24 months, 1955–62	15
Substantial unemployment for 24 months or more, 1955–62	11

[1] Standard metropolitan statistical areas of 250,000 or more.

Sources: 1955–60: U.S. Department of Labor, A Report on Manpower Requirements, Resources, Utilization, and Training (March 1965), p. 152; 1957–62; U.S. Department of Commerce, Area Redevelopment Administration, Migration Into and Out of Depressed Areas, p. 10.

To advocates of the last type of policy, intergovernmental equalization grants appear especially dangerous. These grants, they say, would worsen the situation by weakening the incentives of residents to move elsewhere. Once agan, one cannot simply answer yes or no. Some economic adversity is clearly a powerful stimulant to labor mobility, but large doses of it may have exactly the opposite effect. The poorest families are typically not well informed about oppor-

[41] U.S. Department of Commerce, Area Redevelopment Administration, *Migration Into and Out of Depressed Areas* (September 1964), p. 21.

tunities elsewhere, and they cannot afford to take advantage of the ones they do know about. The mobility study cited above, for example, noted that, "Contrary to expectations, the mobility of people who have been subject to unemployment is barely higher than the mobility of people without unemployment experience." [42] Nor, as tables IV–14 and IV–15 show, do outmigration rates tend to be highest either from areas with the highest unemployment or from counties with the lowest average family incomes. Of course, equalization grants cannot always be made with impunity to labor-surplus areas, but they may, depending upon the uses to which they are put, provide a stronger stimulus to outmigration than economic adversity alone.

TABLE IV–15.—*Percent of families moving between 1957 and 1962, by median 1960 family income in counties of origin*

METROPOLITAN AREAS

South		Other regions	
Median county income	Percent moving	Median county income	Percent moving
$5,950 or more	14	$6,950 or more	15
$4,950 to $5,949	14	$5,950 to $6.949	12
$4,949 or less	12	$5,949 or less	11

NONMETROPOLITAN AREAS

South		Other regions	
$3,950 or more	20	$4,950 or more	23
$2,950 to $3,949	25	$3,950 to $4,949	11
$2,949 or less	14	$3,949 or less	13

Source: U.S. Department of Commerce, Area Redevelopment Administration, Migration Into and Out of Depressed Areas (September 1964), p. 9.

Among the probable uses of unconditional Federal grants, education stands first by a wide margin, and there is ample evidence, illustrated in table IV–16, that geographic mobility is positively and strongly correlated with the average number of years of schooling completed. Grant funds used for public health programs and welfare grants to low-income families with children may be equally, if not even more, effective in raising average educational levels and hence in stimulating, sooner or later, the movement of workers out of depressed areas. Welfare grants, it is true, might lower mobility in the short run, but if they are combined with assistance to all able-bodied recipients to develop their skills and with incentives to encourage job-taking rather than subsidy-taking, these dangers should be minimized.

Equalization grants devoted to health, education, and welfare programs then should have favorable allocation effects even when they are allocated to regions that would benefit from a significant outmigration of labor. Such areas, however, may be inferior choices for the initiation of public works or highway construction, and if so, grant funds should not be used for these purposes. Intrastate fund allocations, in other words, should take regional growth prospects into account. Close working liaisons should be developed between State-local

[42] *Ibid.*, p. 18.

planning and budgetary officials and those Federal agencies, such as the Economic Development Administration and the Office of Economic Opportunity, that are concerned with regional welfare and development. Indeed, there is undoubtedly a need for more intergovernmental programing coordination of all kinds, and a program of unconditional Federal grants to the States should provide an excellent opportunity to promote it.

TABLE IV–16.—*1955–60 migration rates of men in selected age groups, by educational attainment*

Years of school completed	Age group	
	25 to 29 years	25 years and over
No school years completed	13.3	7.5
Elementary:		
1 to 4 years	17.5	9.1
5 to 8 years	23.2	10.8
High school:		
1 to 3 years	25.6	14.7
4 years	28.6	17.5
College:		
1 to 3 years	38.2	22.4
4 years or more	55.4	31.6
Total	31.8	15.7

Source: U.S. Department of Labor, "Report on Manpower Requirements, Resources, Utilization, and Training" (March 1965), p. 155.

If any general conclusion is warranted by the preceding discussion, it would be that unconditional Federal grants are more likely to improve than to distort interregional resource allocation. Either result is, of course, possible in specific instances, but if they are established with some of the safeguards noted earlier, balancing grants should not threaten an efficient geographic allocation of resources. As noted earlier in the chapter, low-income regions in this country have experienced a more rapid rate of economic growth during the postwar period than have the high-income regions. Equalization grants, therefore, should mainly accelerate trends already underway.

EVALUATION OF UNCONDITIONAL GRANTS AND THEIR MAJOR ALTERNATIVES

No government program, including Federal grants-in-aid, is perfect. The final step in evaluating unconditional Federal equalization grants, therefore, is to compare them with the major alternatives for expanding high-priority State and local spending programs and by doing so to assess the relative merits and weaknesses of each. The most appropriate context for this discussion appears to be the one in which unconditional grants were initially discussed—namely a budgetary situation in which at full employment levels of income Federal tax receipts are expanding more rapidly than Federal expenditures. The Federal revenue dividend resulting which might run as high as $5 to $7 billion a year could be used in a number of different ways that would benefit State and local governments. This section considers the main possibilities.

FEDERAL DEBT RETIREMENT

To some, the obvious solution would be to use the revenue dividend to retire part of the public debt. Under the right conditions such a policy would further the achievement of national economic goals and give some assistance to State and local governments. If private and government demands for new output were buoyant enough to create inflationary pressures, some combination of fiscal and monetary restraint would be called for. Using surplus tax revenues to purchase outstanding Federal securities would be one possibility. Compared to tighter monetary controls, such a policy would benefit State and local governments by enabling them to borrow on more favorable credit terms, and therefore to continue their capital expenditures at high levels while other types of spending were being curtailed in the interest of price stability. Some indication of the quantitative importance of such a policy choice may be obtained from the behavior of municipal investment under the tight monetary conditions of 1955–57. Charlotte De Monte Phelps has estimated that during that period tightening credit led to the postponement or cutback of between $200 and $300 million of municipal capital expenditures a year, or some 4 to 7 percent of the total volume then being made.[43] Federal debt retirement, then, is capable of giving some assistance to State and local governments, though its amount is uncertain and its incidence would be concentrated on capital, rather than current, expenditures.

Economic conditions, however, do not always favor the accumulation of Federal budgetary surpluses for purposes of debt retirement. Whenever private demands are relatively weak, such a fiscal policy would, unless combined with sufficiently expansionary monetary policies, tend to keep the economy operating below full capacity levels. Valuable output would thus be sacrificed, and it would include various State and local governmental services for which financing could not be found. Since State-local tax systems have a GNP elasticity that is close to unity (See ch. I), those governments currently tend to lose about half a billion dollars in revenue for every 6.5 billion that GNP falls below its full employment level. In 1964, for example, when the Council of Economic Advisers estimated that GNP was $27 billion below its economic potential,[44] more vigorous expansionary fiscal policies could presumably have raised state and local tax receipts by nearly $2 billion. There is no need to emphasize the importance of such a sum to hard-pressed Governors and city officials.

Skillfully handled under favorable conditions, then, a deliberate program of Federal debt retirement could assist State and local governments in expanding their capital expenditures. In practice, however, these gains might not materialize, and the economy might be kept instead at relatively low, undercapacity levels of income that would curtail State-local expenditures by reducing the tax revenues these governments would have at their disposal.

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[43] "The Impact of Monetary Policy on State and Local Government Expenditures in the United States," in Commission on Money and Credit, *Impacts of Monetary Policy* (Prentice-Hall, 1963), pp. 646–647.

[44] *Economic Report of the President* (January 1965), p. 83. The 1964 level of GNP was $622 billion.

FEDERAL TAX REDUCTION

In considering the case for using Federal tax reduction as a means of avoiding any excess fiscal drag, it is tempting to include the increased State-local tax revenues that would be generated by the movement of GNP closer to its full employment level. Rough calculations, for example, show that State and local taxes would tend to rise automatically by 16 to 24 percent of any reduction that was made in Federal individual income tax receipts.[45] Similar expansions, however, would also accompany the establishment of a program of unconditional Federal grants-in-aid, and therefore they should not be counted as a distinguished characteristic of either fiscal policy.

What is needed, instead, is to compare tax reduction and unconditional grants as alternative means of attaining some given level of GNP. In this context, the distinctive characteristic of Federal tax reduction is that it increases the margin—GNP minus Federal tax revenues—from which State and local governments draw their own tax receipts. Whether they would react to these broadened opportunities by raising their tax rates is debatable. To predict the outcome one must decide whether present State-local tax rates are held down primarily by intergovernmental competition for business and industry or primarily by the extent to which the Federal Government has preempted the tax field.[46] If the tax competition hypothesis is accepted, and the discussion in chapter I indicated that there is much to be said in its favor,[47] Federal tax reduction would clearly not be an effective means of assisting State and local governments. Accepting the second hypothesis makes the evaluation process more complicated, but it would not necessarily change the outcome. If States and municipalities can be counted on to absorb a significant portion of any fiscal slack that is left by Federal tax reduction, they are very likely to do so by expanding property and sales, rather than income, taxes. Since future Federal tax cuts are likely to apply almost exclusively to the individual and corporate income taxes,[48] the end result, in the eyes of many, would be a less equitable tax system. It might also be a less efficient one, unless significant progress were made in solving some of the tax coordination problems discussed in chapter II. Finally, the stabilization powers of the Federal Government would be weakened, and it is highly doubtful that fifty independently acting State governments would prove a reliable substitute.

As a means of assisting State and local governments, then, Federal tax reduction suffers from two major weaknesses: it may not succeed in raising their self-financing powers by very much, and if it does, the Nation may end up with what many would regard as an inferior tax system. Its chief merit is that it does foster State-local fiscal inde-

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[45] Based on the assumption that a $1 billion cut in individual income taxes would increase GNP by $2 to $3 billion, and that State and local taxes, which were 8 percent of GNP in 1963, would expand proportionately; that is, by $160 to $240 million.

[46] For purposes of discussion it is assumed throughout this section that State and local tax rates are not held down simply by lack of voters' desire for more State-local services.

[47] See pp. 23–24.

[48] After the tax reductions made by the Excise Tax Act of 1965, as amended in 1966, Federal excises with a high priority for later reduction or repeal will have an annual yield of less than $2.5 billion. This assumes that the various benefit-oriented excises, together with tobacco and liquor taxes, will continue to be regarded as permanent parts of the U.S. revenue system.

pendence and responsibility, and some of its defects could be minimized by increased use of the tax coordination devices discussed in chapter II. Among the different means of assisting the States both Federal tax reduction and tax coordination deserve serious attention.

TAX CREDITS AND SOURCE-ORIENTED TAX SHARING

Two effective means of circumventing the debilitating effects of interstate tax competition would be Federal credits for specified State and local taxes or a return to the jurisdictions of origin of part of the yield of some Federal taxes.[49] Federal adoption of a fractional credit against State and local individual income tax liabilities, for example, might stimulate States without income taxes to adopt the levy and income-tax States to expand their use of it. If so, this would be a way of reducing Federal taxes without greatly diminishing the relative importance of personal income taxation in the country's total tax structure. Duplicate, or even triplicate, income tax administrations would be maintained, but with extensive use of the coordination devices discussed in chapter II, compliance costs could probably be kept to a minimum.

A major difficulty with fractional tax credits is the great uncertainty that exists concerning their fiscal effects. For this reason they can be opposed both by Congressmen who fear the loss of Federal revenues that would result from vigorous State reactions to the credits and by proponents of higher State-local spending who fear that credits would fail to stimulate much additional State and local tax effort. An alternative that would meet these objections is some form of tax sharing. If x percent of the Federal individual income tax base, for example, were returned to the States of origin each year, State revenues would be raised in a relatively predictable way; and this plan, unlike one that involved sharing a fixed percentage of Federal tax revenues, would insulate State and local governments from the effects of countercyclical changes in Federal individual income tax rates. These gains, however, would be accompanied by a centralization of tax powers that could be avoided under a tax credit plan.

Both tax credits and source-oriented tax sharing have one important weakness—neither is capable of reducing existing inequalities in State and local fiscal capacities. For this purpose one must rely either on Federal grants-in-aid of some kind or on direct Federal income maintenance programs (including negative tax credits).

CONDITIONAL AND UNCONDITIONAL FEDERAL GRANTS-IN-AID

In principle, conditional and unconditional Federal grants serve two separate and distinct purposes. Conditional grants are needed to optimize the allocation of resources to State-local spending programs with significant external benefits; and unconditional grants are needed to balance whatever basic fiscal deficiencies prevent the States from financing internal program benefits at reasonable tax rates. In practice, these distinctions are blurred by the lack of precise measures of the relative importance of external and internal benefits,

[49] Both of these tax coordination devices are discussed in detail in ch. II.

but there is still much to be said for a Federal system that includes both kinds of grants.

Consider, by way of illustration, a State spending program that generates external benefits whose importance is indeterminate within a wide range, say between 10 and 40 percent of total social and private benefits. According to the theory presented in chapter III, functional, open-end Federal grants, covering 10 percent of total costs, would expand that program and move its operation closer to the levels justified by its total benefit-cost ratio. To stop Federal aid at that point, however, would not guarantee optimal results. Even if external benefits were only 10 percent of total benefits, some States might be unable to finance their own 90 percent shares, and if external benefits were more important than that, even States with ample funds would lack incentives to give the program as much support as it should have.

One solution, of course, would be to increase the Federal share under its functional grant program. If the open-end feature of the grants were maintained, however, the danger of distorting State budgeting by paying for internal benefits of a specific type would increase. Moreover, the higher the Federal share, the greater would appear the need for detailed Federal controls and safeguards. Beyond some unknown point, in short, the Federal Government could reasonably be accused of unwarranted interference in purely local affairs.

Nor would a shift to closed-end functional grants be likely to improve matters much. There might, it is true, be somewhat less pressure for Federal controls because each year's total appropriation could be fully determined in Washington, but at the same time Congress might be induced to raise the Federal share beyond justifiable levels. Under the circumstances assumed, for example, a 50–50 shared-cost program would produce an unpredictable mixture of nonoptimal budgetary decisions. Because external benefits are no more than 40 percent of total benefits, each State would have a strong incentive to expand operations so as to qualify for the maximum Federal grant. However, incentives for expansion would be deficient beyond that point, because external benefits would be at least 10 percent of the total benefits. Only by pure chance would any one State program end up close to its optimal operational level.

Another solution would be to restrict the open-end, functional Federal grants to a 90–10, State-Federal, matching basis and to initiate a program of unconditional grants. Greater aid could then be given to the low-income States, and all States would be helped while they were left free to determine for themselves the specific internal program benefits they wished to enjoy. The maintenance of functional grants at minimum levels, however, would risk a serious overexpansion of unconditional grants. As these "costless" funds were increased, States would be more and more tempted to spend them carelessly and wastefully, and in any case, they would not be induced to give sufficient support to programs with above-minimum benefit spillouts.

While it seems clear that both functional and unconditional Federal grants are needed, it is not easy to say in what relative amounts. Uncertainty about economic effects creates a need for flexibility, for compromise solutions that minimize the risks of serious distortions,

and for trial-and-error, or hopefully, trial-and-success procedures. If one were starting out anew one might begin with a set of minimum-level functional grants and a modest-sized program of unconditional equalization grants. When the State and local governments had adjusted to these, rate of return tests could be used to provide a partial answer [50] to the question of what should be done next by way of intergovernmental assistance. If external benefit programs, for example, came out better than programs that generated internal benefits primarily, further expansions of functional grants would be called for. If internal benefit programs also showed superior rates of return, compared to the relevant private rates, more unconditional grants would be indicated, provided that State and local governments were, by and large, making as much tax effort as could reasonably be expected of them. As is already done in this country, functional grants could also be used to finance experimental and demonstration projects that would provide some of the data needed for the rate-of-return tests. Finally, fiscal research could be directed at measurements of the effects of Federal grants on different types of State and local expenditures so that Congress could choose more confidently and accurately the best means of achieving desired levels of public services. By these means, and with good luck, one might gradually but steadily approach that mythical goal—the ideal Federal grant-in-aid system that an all-knowing superbeing could have set up in the first place.

In this country, of course, we are presently very far from beginning anew. Functional Federal grants have been growing rapidly and are likely to continue to do so. Not the least of the merits of a new program of unconditional grants would be the insurance it would provide against excessive use of the functional approach—against budgetary distortion at the State and local level and more control from Washington than is warranted by interstate and national benefit flows. People worry whether unconditional moneys would be well spent, and they are seldom put to much trouble to find evidence to justify their concern. One of the dangers of generous functional Federal assistance, however, is that it is likely to keep States in a dependent and inferior role and to prevent them from showing how well they could do on their own. With unconditional grants in their treasuries, States could take a fresh look at the programs that seem best to serve their own individual needs and tastes. The results might be surprisingly good, even from the point of view of outsiders.

If unconditional Federal grants are initiated, they should be responsive to economic growth and to rising price levels, since State-local fiscal deficiencies are likely to increase with both. One way of doing this, and of helping States to plan by enabling them to forecast their future grant receipts with reasonable accuracy, would be to distribute each year x percent of the Federal individual income tax base, that is, x percent of the total taxable income reported on Federal individual tax returns. Between 1955 and 1963, while its statutory definition remained unchanged, the base grew by 64 percent, compared

[50] Partial because benefit-cost analysis can deal only with those benefits that can be quantified. For an illuminating discussion of the problems involved here, see Robert Dorfman (ed.), *Measuring Benefits of Government Investments* (Brookings Institution, 1965). On the other hand, computations of rates of return are much more manageable than estimations of external or internal benefit ratios, because the latter require knowledge of not only all program benefits but also their geographical incidence.

to an increase of only 47 percent in GNP. If this relationship continues to hold and GNP grows at 5 percent per annum, taxable income should rise from nearly $245 billion in 1965 to $340 billion in 1970:

Year	Federal individual income tax base	
	Amount (billions)	Percentage of GNP
1955	$128	32
1963	209	36
1965	244	37
1970	340	40

Grants that were proportional to the individual income tax base, then, would have a significant built-in growth component. Some automatic falloffs during recessions could be expected, but for short economic declines the loss of grant funds is not likely to be great, and in more severe recessions, Congress could, if it wished, provide supplementary allocations.[51] To relate the grants to taxable income instead of income tax liabilities would enable the Federal Government to vary its tax rates countercyclically without creating thereby procyclical fluctuations in its grant distributions.

CONSOLIDATED GRANTS-IN-AID

Federal grant assistance, allocated by broad program areas with few or no controls, is an intermediate solution to intergovernmental fiscal problems, lying between open end, matching, functional grants on the one hand, and unrestricted general grants on the other. As noted in chapter III, some consolidation of existing Federal grants may well be justified by the lack of any important differences between the external-internal benefit ratios of the separate programs. Most advocates of consolidated grants, however, go well beyond this in their proposals.[52] Federal assistance, in their view, should be given for education, health, public welfare, and other similar, broad program areas. Since the amount of money allocated to each program would presumably reflect its relative importance from a national point of view and since the use of the money within each program area would be left entirely to State and local governments, the plan would combine some attention to national priorities with a high degree of fiscal decentralization.

Simply to substitute consolidated grants for all existing programs, however, would result in suboptimal support for all State-local programs with important benefit spillouts.[53] This deficiency could be eliminated either by retaining enough functional programs or by distributing consolidated grant funds in a way that stimulates State-local

[51] During the 1953–54 recession, for example, taxable income fell off by only 14 percent of the decline in GNP, and in 1957–58 it moved countercyclically. See Richard Goode, *The Individual Income Tax* (Brookings Institution, 1965), p. 347, and Wilfred Lewis, Jr., *Federal Fiscal Policy in the Postwar Recessions* (Brookings Institution, 1962), pp. 43–44.

[52] See, for example, George C. S. Benson and Harold F. McClelland, *Consolidated Grants: A Means of Maintaining Fiscal Responsibility* (American Enterprise Association, December 1961).

[53] The same criticism aplies to Senator Goldwater's proposal, made during the 1964 presidential campaign, that present programmatic grants be replaced by completely unrestricted lump-sum cash grants. See, for example, *Congressional Quarterly*, Oct. 23, 1964, p. 2527, and Milton Friedman, "The Goldwater View of Economics," *New York Times Magazine*, Oct. 11, 1964, pp. 136–137.

expansions of external-benefit activities. Title I of the 1965 Federal school aid bill provides a good illustration of the latter method. The maximum basic grant depended on two variables: the number of school-age children from poor families in the State and average per-pupil State education expenditures. By expanding the latter a State can qualify for a larger basic grant. In addition, special incentive grants based on the amount by which the growth in local school expenditures between 1964 and 1965 exceeds 5 percent were authorized for fiscal 1967.

Basic title I grants take into account both State-local tax effort and the incidence of poverty. Their redistributive effects are shown by the $1 billion allocation that is expected to be made in fiscal 1966:

Quintiles of States based on 1963 per capita income	*Percentage of basic grants*
Highest	27
2	19
3	9
4	17
Lowest	28

Compared to the distributions given earlier in table IV–8, this one apportions relatively large amounts to the bottom quintile and relatively few funds to the second and third quintiles. Use of the funds is subject to few Federal restrictions;[54] consequently the program exemplifies an interesting compromise between the more specialized and closely controlled grant programs discussed in ch. III and completely uncontrolled Federal aid.

MINIMUM-PROGRAM, EQUALIZATION GRANTS

Achieving, with the assistance of Federal grants, a nationwide minimum level of specific public services commands wide support.[55] Such a policy is justifiable either on welfare grounds or by benefit spillouts, but the welfare case is much the stronger. Minimum-program grants, therefore, cannot be regarded as an acceptable substitute for optimizing functional grants, but they might serve as a substitute for unconditional grants or as a factor to be used in designing them.

If it could be shown that the external benefits of State-local spending programs were significant up to some readily identifiable level of operations and then fell off abruptly beyond that point, Federal matching aid would be called for in large amounts only up to that point. Beyond it, benefit spillouts might not be considered important enough to cause serious distortions in State-local budget choices, and the result would consequently be a set of fixed Federal grants that helped finance a foundation, or minimum, program in each State. The nature of the external benefits discussed in chapter III, however, leads one to doubt that they do behave in this way. Instead it is more likely that external benefits maintain their importance as program levels are expanded. If this is so, minimum-program grants would risk perpetuating suboptimal service levels in the affected areas.

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[54] Public Law 89–10, signed by the President on Apr. 11, 1965, simply states that title I funds are intended primarily for programs to assist educationally deprived children from low-income families. Within these general guidelines, local school districts are given broad spending discretion, though their plans must be approved by State and Federal educational agencies and periodic progress reports must be made to the same authorities.

[55] In his comprehensive survey of Federal grant programs Paul Studenski, for example, included it among the four basic purposes that those grants had been set up to serve. See his "Federal Grants-in-Aid," *National Tax Journal*, vol. 2 (September 1949), pp. 198–199.

The other justification for minimum-program grants rests on straight ethical, or welfare, grounds. Every citizen, it may be urged, is entitled to enjoy some minimum level of public services without having to pay excessively high taxes. In general, this could be accomplished by designing a program of Federal grants so that:
$G_i = N_i - R_i$, where
G_i = the foundation grant to be made to the i-th State,
N_i = the cost of the minimum programs in the i-th State, and
R_i = the revenue that can be raised by reasonable levels of taxation in the i-th State.

The total grant could either be apportioned by program before being distributed to each State, or it could be given unconditionally so that each State would be free to do its own apportioning. The first method is a demanding one. In principle, it would require a rigorous specification of the minimum beneficial services sought in each area of governmental operations and then an objective measurement of the costs of obtaining those services in different parts of the country. There is no need to stress the difficulties involved in either procedure. Widespread agreement about minimum service levels is unlikely, and governmental input-output relations cannot be measured with a high degree of accuracy.[56] In addition, extensive Federal controls would presumably be required to insure the effective use of the grant funds in each program area.

Trying to guarantee each citizen a specific minimum-sized basket of public goods, therefore, is likely to prove an expensive and controversial undertaking. The second, and simpler, method would be to guarantee only the means needed to purchase the minimum basket, leaving it up to each grantee to decide whether it wanted that basket or some alternative one. In effect, this approach leads to a set of unconditional Federal equalization grants, the amounts of which are determined, at least in part, by reference to the costs of minimum public service levels in the different States and to the revenues which each could contribute on its own if it taxed its residents at, say, average tax rates for the country as a whole.[57] Having determined the grants in this way the Federal Government might then wish to make the maintenance of those standard tax rates either a prerequisite for the receipt of any Federal money or a factor in determining what proportion of its total entitlement each State qualifies for.

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[56] In Japan these problems are given explicit recognition by including in the grant formula only 75–80 percent of the recipient's standard tax revenues (R_i), the remainder being regarded as a contingency fund for the grantee to fall back on whenever the N_i are underestimated.

[57] The tax rates actually imposed in States of average income and wealth seem as good a determinant of the R_i as any. One alternative, which would derive the standard tax rates from the specification of minimum program levels, would be to proceed as follows:
Given C_i = measure of the fiscal capacity of State i,
(1) Set $R_i/C_i = k$ for all i, and make
(2) $\Sigma G_i = \frac{1}{2}\Sigma N_i = \Sigma R_i = k\Sigma C_i$, then

$$G_i = N_i - R_i$$
$$= N_i - kC_i \text{ from (1)}$$
$$= N_i - \tfrac{1}{2}\Sigma N_i/\Sigma C_i \cdot C_i \text{ from (2)}$$

Under such a program the Federal and State governments would share minimum-program costs equally and each State would contribute equally, relative to its own fiscal capacity. The standard tax rate, k, would be one-half of the ratio of total costs to total national fiscal capacity:

$$k = \tfrac{1}{2}\Sigma N_i/\Sigma C_i.$$

Grants with these characteristics were designed as the basic kind of Federal equalization grant by the Advisory Committee on Intergovernmental Relations in their *The Role of Equalization in Federal Grants*, p. 49. See also Selma J. Mushkin, "Barriers to a System of Federal Grants-in-Aid," *National Tax Journal*, vol. 13 (September 1960), pp. 215–217.

INCOME MAINTENANCE PROGRAMS

The United States has at present a complex set of income maintenance programs which involve all three levels of government and transfer income to rich and poor, old and young, sick and healthy. That these programs are not sharply focused on the poor has long been known, at least to those who cared to look. But only with the recent greatly increased interest in the problems of poverty have some of the quantitative dimensions of the situation been clarified. In fiscal 1965, for example, "an estimated $20 billion of the $40 billion total spent on these public transfer payment programs went to persons who were or would otherwise have been below the poverty-income line; these payments helped to raise some 3 million households out of poverty, but about 12 million units still received insufficient income to meet the minimal living levels now used to define poverty." [58] In addition, half of the poor, or some 17 million persons, received no public transfer income at all. According to official estimates, "to eliminate completely the poverty-income gap—the amount by which total money income falls short of meeting the poverty-income standard—would require that almost $12 billion be added to the income of the poor." [59]

These deficiencies have stimulated considerable interest in the development of new Federal income maintenance programs. One possibility would be to expand the scope and size of existing general assistance payments, now entirely financed by State and local governments, by establishing a new program of matching Federal grants for this purpose. Another possibility would be for the Federal Government to adopt what has come to be called a negative income tax. There are several variants of this proposal,[60] but all would make use of the existing Federal individual income tax administrative apparatus to make annual money payments to the poor that would be a positive function of the gap between family income and the poverty-income standard established as appropriate for that family. Thus the Federal Government might pay 20 percent of the first $500 of deficient family income, 30 percent of the next $500, and 50 percent of any additional deficiency.

The important question for this study is the extent to which these Federal income maintenance programs would be substitutes for a new program of unconditional Federal grants. Though no specific answer can be given until the nature of the new income maintenance programs is known, the general prognosis seems to be that only a limited amount of substitution would occur. Federal matching grants for general public assistance, for example, might well increase the volume of State-local expenditures for this purpose, thereby intensifying the fiscal pressures on other spending programs. Any additional income support for the poor would, or course, raise incomes and expenditures, and hence State-local tax receipts, especially in the low-income States.

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[58] *Economic Report of the President* (January 1966), p. 114.
[59] *Ibid.*, p. 112. The poverty-income standard was defined by the Social Security Administration in response to the passage of the Economic Opportunity Act of 1964 and takes account of differing family sizes and composition and differences between living costs in urban and rural areas. In 1964, for example, the poverty-income line for four-person nonfarm families was set at $3,130, and for farm families of the same size at $2,190.
[60] See, for example, James Tobin, "On Improving the Economic Status of the Negro," *Daedalus*, vol. 94 (fall 1965), pp. 891–894; "Income Tax That Pays the Poor," *Business Week* (Nov. 13, 1965), pp. 105–106; and Christopher Green, *Negative Taxes and the Poverty Problem* (The Brookings Institution, forthcoming 1967).

However, a set of unconditional equalization grants would, as they were spent by the recipient governments, have many of the same feedback effects. What expanded Federal income maintenance programs would accomplish is the reduction, or even the elimination, of one of the important deficiencies in existing State-local expenditure programs. Other deficiencies, it is true, could also be reduced if Federal income subsidies were made generous enough to raise both the consuming and the taxpaying abilities of the poor by substantial amounts. This, however, seems an unlikely contingency in the near future. In the meantime, the other State-local spending deficiencies will remain, and, depending upon how serious they are adjudged, will call for the use of unconditional Federal grants or some of the other Federal aids discussed earlier.

SUMMARY

In this section it has been assumed that current State-local fiscal efforts, and hence State-local expenditure levels, are below the amounts desired by most people, and the major means of eliminating these deficiencies have been compared and evaluated. The range of choice is a broad one, and no one way is likely to prove sufficient to the purpose at hand. The degree to which each method should be used depends upon the strength of the different factors that make for inadequate State-local tax efforts; therefore those factors are listed below, along with the Federal fiscal policies that would appear to be most effective in dealing with them.

Reason for inadequate State-local spending levels	*Appropriated Federal fiscal policies*
1. State-local inertia and inefficiency.	Federal technical assistance with both expenditure and tax programs. Tax coordination (ch. II).
2. Federal preemption of the tax field.	Federal tax reduction combined with tax coordination policies designed to maintain the efficiency, equity, and stabilizing powers of the national tax system. Tax credits.
3. Benefit spillouts from State-local expenditure programs.	Functional, open end, matching grants (ch. III). Consolidated grants.
4. Interstate competition for business.	Tax credits. Source-oriented tax sharing. Consolidated grants. Unconditional grants.
5. Inadequate fiscal capacities____	Unconditional equalization grants. Consolidated equalization grants. Federal income maintenance programs.
6. Inadequate rate of growth of full-capacity output (including investment by State and local governments).	Budget surpluses; Federal debt retirement; easy monetary policy.

This listing includes all of the alternatives considered except minimum-program equalization grants which, for reasons given earlier in the section dealing with them, are not regarded as effective means of dealing with either external benefit flows or inadequate State fiscal capacities. Minimum-program computations, however, might prove helpful in determining both the total amount and the interstate distribution of any unconditional Federal grants that are inaugurated.

If, as many believe, both interstate tax competition and inadequate fiscal capacities are important deterrents to the achievement of optimal State-local spending levels, only unconditional or consolidated equalization grants would help to solve both problems at once. Lacking these grants, the Federal Government would need to combine two or more policies such as tax credits to deal with interstate competition and equalization grants made only to the poor States to deal with inadequate fiscal capacity.

Unconditional State Grants

Whenever States wish to offset the fiscal deficiencies of their local governments with unconditional grants, they are likely to enjoy one advantage that the Federal Government lacks—the recipients, being more homogeneous than the individual States, can be grouped on the basis of need into a limited number of classes. Members of each class can then be offered assistance that will enable them to maintain either minimum program levels at average tax rates or, if greater equalization is desired, average program levels at minimum tax rates. An interesting example of the latter plan is the grant program recently proposed for Canada by John F. Graham.[61] Under it, local governments would be grouped according to the factors, other than income and wealth, that determine per capita local government expenditures, and for each separate class, j, the average amount spent per person on all internal-benefit programs, $\bar{E}_j$, would be estimated. The standard local expenditure for any government, i, in class j would then be:

$$E_{ij}=P_i\bar{E}_j, \text{ where } P_i \text{ is the population in jurisdiction } i.$$

For each class of municipality a set of standard tax rates would be derived by comparing standard expenditures with local fiscal capacities:

$k_{ij}=E_{ij}/B_{ij}$, where B is the tax base used in all municipalities, or if more than one tax is used, some appropirate measure of local fiscal capacities.

From these rates the smallest one would be selected to serve as the uniform tax rate in the grant allocation formula:

$$k_{oj}\leq k_{ij}.$$

The unconditional grants to be made to each local government would then be:

$$G_{ij}=P_i\bar{E}_j-k_{oj}B_{ij}.$$

[61] John F. Graham, "Fiscal Adjustment in a Federal Country," *Inter-Government Fiscal Relationships*, Canadian Tax Papers, No. 40 (Canadian Tax Foundation, December 1964), p. 23.

In effect, this type of grant program would guarantee each local government's ability to purchase average service levels at minimum tax rates for its particular class, and within each group grants would be made to all but the richest jurisdictions.[62]

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UNCONDITIONAL GRANTS-IN-AID

Not unexpectedly, discussion of the 1964 Presidential Task Force plan for unrestricted Federal grants to the States brought forth a well-balanced blend of sympathy and skepticism. Supporters of the proposal stressed the capacity of State and local governments for imaginative programing and the extent to which this could be strengthened by giving them additional funds without strings attached. Others felt that because the Federal Government tends to experiment more successfully than the States, grant funds should always be extended for specific purposes and with appropriate controls attached. One interchange illustrates the extent of the disagreement. An opponent said:

> As I watch the growth of the bureaucracy and its behavior at all levels of government, I realize that the tendency is to solve problems by doing more of what they are doing. If you give more money to the States and cities unconditionally and you have a crime problem, they hire more police. This doesn't seem to have much impact on the crime problem. In fact, it may complicate it because then you have to watch crime in the police force, too. . . . If you give it to the welfare workers they will want more extensive welfare programs of the kind they are already familiar with, and so on down the line.

A supporter stated:

> . . . I think it is a strange doctrine to think that the Federal Government is superior as an experimenter to the State governments. I think most of the political history would argue otherwise, that you had in the States essentially laboratories for all kinds of economic and social experiments, and more often than not the Federal Government has been the follower rather than the leader in this.

The past, of course, is not necessarily an accurate guide to the future, and several experts stressed the ability of Federal block grants to bring forth new and better programs at the State and local levels and to increase the administrative effectiveness of those governments:

> . . . One of the major reasons for the Federal grants is to stimulate innovation in the programs and processes within the country. Those of you who follow the researches in the area of grants will remember the studies made by Paul Mort in the educational field. He demonstrated (taking the grant system of Pennsylvania over a considerable period of time in relation to school programs and State aid) that the factor which seemed to be most important in the process of innovation in the school system was fiscal elbow room on the part of the local school board and the school superintendent.

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[62] The plan can be readily shifted to one for minimum-program grants by substituting F_{ij}, the cost of some specific foundation program, j, in each government unit, i, for E_{ij}.

> Now we can all say well, of course, we all knew that. But it was a very useful thing to have the statistical elements examined with care and the elements of quality priced out with reference to the achievement of the educational system because they gave tests—standardized tests in different school systems—and demonstrated that there was introduction of new processes, and that these new processes paid off with reference to defined goals, and that this took place where there was fiscal elbow room.

Stressing both the additional funds and the new responsibilities that unconditional grants would confer on the States, another argued:

> . . . just the existence of this money is going to provide a lot of encouragement to all of the pressure groups which in States like New York and California we have. And this is what adds to the administrative effectiveness, and I think that the quickest way to improve the administrative effectiveness of a State is to increase the complexity of its programs and the responsibility of its officials, and hopefully, there will be talent—a shortage of talent at first in some cases obviously, but this is not really very important, and hopefully the salary levels, etc., of officials will have to go up with increasing responsibility.

In order to maximize the chances of securing these administrative advantages some participants argued for a twin program of unconditional block grants and technical assistance to the recipients by the new Federal Department of Housing and Urban Development. The importance of having this combination from the very beginning was stressed:

> . . . The time when innovation can be built in is the first 3 years after the receipt of the unearmarked block grant, because at the end of that period it will be completely absorbed into a pattern of habit and nothing will be changed. Therefore, during this period of the initial receipt there must be techniques of technical assistance which will lead the States to desire to make workable plans, which after public discussion will be acted on by the newly modified legislative bodies that will have a better recognition of urban requirements.
>
> In this way you would introduce rationalization and measurement of needs so that the unconditional block grant would come to the localities, to the States first and then to localities, on the basis of a public exposure of the opportunity, and with technical assistance in the development of those plans and programs.

While the theoretical economist typically insists that a new governmental program be judged by comparing it with all alternative uses of the relevant resources, the political economist will often direct his attention to a more restricted set of alternatives that he regards as politically feasible. At the conference it soon became clear that there was no agreement as to whether Federal block grants would be substitutes for, or complements to, other Federal aids to State and local governments, and that the answer given to this question would influence individual attitudes to the proposed fiscal innovation. In the view of one participant, presidential support of the special task force report in the fall of 1964 would have precluded adoption of the aid to educa-

tion bill as well as some of the other new grant programs enacted in the first session of the 89th Congress. Another, however, argued that the forces supporting functional grants are so great that block grants would in no way substitute for them.

Since one of the main purposes of unconditional grants is to give substantial financial support to the poorer States, enactment by the Federal Government of a negative income tax, a long-standing proposal that seems to be receiving increasing attention of late, must be regarded as a major alternative. Though its merits and weaknesses received only cursory attention, the negative income tax proposal clearly appeared to some to have a prior claim on Federal financial resources which, when exercised, might well eliminate any need for Federal block grants. Others, however, reacted in exactly the opposite way, thus providing, if nothing else, a strong incentive to economic researchers to try to resolve some of these differences by means of quantitative analyses of the two proposals.

One of the more difficult questions for such research to answer would be the extent to which unconditional Federal grants would be used to lower State-local tax rates rather than to expand expenditures. Uncertainty on this score clearly makes the block-grant plan less attractive in the eyes of some, while others, as the following remark indicates, regard it with equanimity:

> I think the major point has to be made in terms of the fact that this plan is viewed as an alternative to a further Federal tax cut, and I favor this plan even if it doesn't add a nickel to State-local expenditures and even if it doesn't add one point to the intelligence quotient or ability quotient of State-local administrators, because if it doesn't do either of those things then what it must do by definition is to reduce the extent to which State and local governments will depend upon taxes on beer and cigarettes and property and general consumption, and even some of their peculiar income taxes; and if it achieves that latter objective, and only that latter objective, I am all for it because of the improvements that I can see forthcoming in terms of resource allocation, and certainly in terms of distributional effects of the overall Federal-State-local tax system.

A second uncertainty, of perhaps even greater importance, concerns the extent to which unconditional grants would be passed on by the States in some reasonable fashion to local governments, particularly those in urban areas. Those optimistic about the plan stressed the increased powers the cities are likely to derive from legislative reapportionments and cited as hopeful evidence such fiscal reforms as those under serious consideration in Maryland. The skeptics, however, remained unconvinced, tending to feel that solutions to the Nation's metropolitan fiscal problems would have to be sought elsewhere.

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OUR HARD-PRESSED STATE AND LOCAL GOVERNMENTS*

BY HARVEY E. BRAZER

Is the "Heller plan" to channel a percentage of Federal revenue to the States—or some other form of fiscal federalism—the best answer to their growing financial plight?

"Every single solitary Governor of a State in the Union who is doing the job that should be done faces tax increases," said California's Gov. Edmund G. (Pat) Brown to his fellow Governors at their 1965 national conference. "We have state and local governments," added Michigan's Gov. George Romney, "that are largely obsolete, underfinanced, and badly in need of modification."

The views of Democrat Brown and Republican Romney about the financial plight of State and local government are practically universal among elected officials at these political echelons. In their hard-fought race for New York's mayoralty last November, both Republican John Lindsay and Democrat Abraham Beame bluntly stated that the ultimate answer to the perennial financial plight of the Nation's largest city can only come from Washington. And, given the fairly negligible 13 percent of the vote that went to Conservative William Buckley, most of the voters seemed to agree.

How has such a situation come to pass in an era when receipts of State and local governments have grown faster than ever before? Between 1946 and 1964, for example, general revenue receipts of these governments (excluding insurance trust, utility, and liquor store revenues) rose from $11.7 to $68.5 billion. Tax receipts alone climbed from $10.1 to $47.7 billion, while Federal aid jumped from $0.9 to $10.8 billion. Expenditures, however, have grown apace, rising at the rate of 10 percent a year to a 1964 level of $69.3 billion compared with $11 billion in 1945.

On the surface, the absence of a large gap between aggregate expenditures and revenues might suggest that all is well in the fiscal position of State and local governments. But this is an illusion created, in part, by their very stringent borrowing powers that tend to limit expenditures to revenues and, in part, by the fact that in the aggregate data, deficits incurred by some units are offset in any one year by surpluses realized by others.

State-local expenditures are constantly tending to outrun revenues. The key problem here is the tax base. While Federal income tax receipts rise in response to an expanding economy, property, and sales taxes—the principal revenue producers at the State and local level—are far less responsive to increases in economic activity. At the same time, throughout the postwar years expenditures of State and local

*Reprinted from *Challenge*, January–February 1966.

governments have risen faster than all other sectors of the economy by a substantial margin. As a consequence, in order to keep revenues abreast of expenditures, it has been necessary to increase tax rates frequently as well as to introduce new taxes.

The record in this respect is not available for local governments, but it is clear for the States. In 1965, legislative sessions were convened in 47 States. In 32 of these, new taxes were adopted or rates of existing taxes were increased. Nebraska adopted individual and corporate income taxes; New York and Idaho adopted sales taxes; seven States raised individual income tax rates (by as much as 30 percent in Arizona); six States increased their tax rates on corporate income; seven States raised sales tax rates; and motor fuel, cigarette, tobacco products, and alcoholic beverage tax rates were increased respectively, by 9, 22, 5, and 5 States.

Other measures designed to increase State receipts included the adoption of income tax withholding by three States and the extension of the sales tax in six States to transactions that were previously exempt. All of these actions taken together are expected to increase annual State tax receipts by close to $1.5 billion, more than 5 percent of 1964 receipts.

This array of State tax actions is not unusual or unique. Similar steps have been taken by the State legislatures in virtually every odd-numbered year since 1951, when most States had depleted the surpluses accumulated in wartime and were faced with burgeoning expenditure demands and lagging revenues. At this writing, New Jersey is the lone State without either a sales tax or an individual income tax, and 25 States now employ both.

As for the local governments, the postwar years have witnessed the widespsead adoption of sales and income taxes, particularly by municipalities. The extensive local use of these taxes, however, is still limited to a few States, notably California, Pennsylvania, New York, Ohio, Illinois, Missouri, Colorado, and Michigan. In the aggregate, the property tax, now virtually abandoned by the States, still accounts for 85 percent of total tax receipts of local governments, and effective property tax rates continue to mount everywhere.

Plaguing the States and their local subdivisions is the ever-present threat, both real and imagined, of competition for industry and trade from low-tax jurisdictions. This factor, and limitations on taxing powers—local property tax rate limits, constitutional barriers to income taxation in such States as Illinois, Pennsylvania, and Washington, and the denial of nonproperty taxes to local governments in many States—point up the sharp contrast between the Federal Government's ability to raise revenue and that of State and local governments.

The fiscal position of the Federal Government presents a far different picture. Expenditures have continued to grow, but at a lower rate than the economy's total output. But revenues, at constant tax rates, tend to increase much more rapidly than gross national product or national income. Thus the Federal Government's tax reductions of 1962, 1964, and 1965, amounting to $20 billion per year at the current level of economic activity, have been accompanied by a reduction in the annual budget deficit. Moreover, if the annual rate of growth experienced in recent years continues, revenues will increase by more than $7 billion per year.

But budgetary expenditures (assuming there is no major defense buildup) are unlikely to rise by more than $3 to $4 billion a year.

It follows, therefore, that the Federal budget, in the absence of further tax cuts, threatens to become a serious impediment to continued growth and the attainment of an acceptable level of unemployment. Given the pressing financial problems of State and local governments, and the distribution of functional responsibilities among various levels of government, the appropriate choice does not appear to lie between sharply increased expenditures on Federal functions and further tax reduction. Rather, it lies between tax reduction and substantially increased Federal aid to the States. Under present circumstances the second alternative certainly has a great deal to commend it.

Even if the receipt of additional Federal funds resulted only in a reduction in State and local taxes on a dollar-for-dollar basis (in other words, State-local tax cuts instead of a Federal one), the advantages would be appreciable. In contrast to the progressive Federal tax system, State and local taxation, dominated by property and sales taxes, is highly regressive. It follows, therefore, that substitution of Federal for State-local taxes is virtually certain to increase proogressiveness or reduce regression in the overall system. This substitution is also likely to bring about greater equality in the expenditure benefit to tax burden ratio experienced by people of similar income and wealth living in different parts of the country.

And, finally, the greater responsiveness of Federal taxes to change in the level of economic activity means that the substitution of Federal for even a small proportion of State-local taxes will improve the built-in flexibility or automatic stabilizing influence of the total tax system.

It is, of course, a matter of value judgment as to whether these gains are offset, or more than offset, by the accompanying reduction in local fiscal responsibility. But State and local officials and legislative bodies are accountable for the efficient use of public funds irrespective of their source, and a dollar of Federal money wasted is just as costly to a State as the waste of any other dollar. The frequently voiced opposition to Federal aid that rests on the argument that it is wasteful because of the costs of sending the money to Washington and then returning it can hardly be taken seriously, at least in the present context. The fact is that Federal tax collection costs are typically far lower than similar costs incurred by State and local governments. In my own judgment, therefore, the gains exceed any likely losses by a very comfortable margin.

Federal aid thus far has been almost exclusively in the form of matching conditional grants-in-aid. These grants ordinarily require that the States and other recipient units must spend at least some funds of their own in order to qualify to receive Federal money. But since the matching funds may be financed either by increasing State and local taxes or reducing expenditures on other functions, the matched-grant approach does not insure that Federal aid is not substituted for local taxes.

On the plus side, conditional grants-in-aid permit the Federal Government to insure minimum levels of service with respect to the aided functions. Where there is a major national interest in the nationwide attainment of such service levels, this is an important advantage of

this form of aid. But it also may have the effect of forcing the States to divert funds from nonaided services, where the need may in fact be even greater. Budgetary discretion is therefore constrained, and efficiency, in terms of the use of public funds to meet the most urgent needs, may suffer.

It is often argued that Federal grants-in-aid do release State and local funds for financing nonaided services. But this is true only in those areas that would have provided the level of services required by the Federal Government in the absence of those requirements. The outcome in practice, therefore, is almost inevitably one in which the budget-distorting influence of conditional grants-in-aid varies inversely with the economic well-being of the State.

There is undoubtedly a role to be played by Federal grants-in-aid. But assuming, as we do here, that the Federal Government should finance a larger share of total governmental expenditures, there is much to be said for taking a close look at the alternative ways in which it might achieve this end.

One such alternative is Federal assumption of functions that are now in the hands of State and local authorities. But in the face of wide diversity of local needs and tastes across the country, there are probably very few functions or subfunctions that are appealing or appropriate candidates for this treatment. Those that are involve services with very large "spillover" effects—services that do not readily benefit the taxpayers of any one State. This will frequently explain why some services are not provided at all, or are provided inadequately. It undoubtedly goes far to explain the failure of the States to take appropriate action to prevent the pollution of the Great Lakes or the Ohio River, for example. In cases of this kind, there may be no reasonable way to get a job done that everyone seems to agree should be done except by having the Federal Government do it.

Another means of providing financial assistance to the States that has frequently been advocated involves Federal relinquishment of tax sources and their use by the States. The tax on local telephone service has been a favorite candidate for this role. With its repeal by the Federal Government as of the beginning of this year, it will be interesting to see how much of the one-half billion dollars of its yield will in fact be taken up by the States. As a discriminatory tax on consumption and a tax on business costs, there is little to commend it; our overall tax system will not be improved if it should be replaced by comparable State taxes. Other candidates are similarly unpromising and, generally, less likely to yield significant revenues. Moreover, like the tax on local telephone service, they would mostly help those States that are least in need of assistance.

A third alternative is the allowance of a credit against Federal income taxes for State or local taxes paid. This device would help only the taxpayer immediately and directly, but, it is argued, it would enable the States to impose additional taxes in the amount of the credits allowed without adding to the net tax liabilities of taxpayers. Because the amount of sales tax paid by any one taxpayer is extremely difficult to ascertain, and because of the likelihood that renters as well as owners bear property taxes, the only attractive prospect for the credit is in the income tax. But 16 States do not improse general indi-

vidual income taxes, and some of them are constitutionally prohibited from doing so. In addition, the tax credit device would aid the richest States most and the poorest States least—and, in this sense at least, would appear to entail an inefficient use of Federal funds. Furthermore, there seems to be nothing to be gained through an approach under which the States impose taxes so that they may, in turn, be "forgiven" by the Federal Government.

This brings us to the most recently advocated form of Federal financial assistance to the States—the so-called Heller plan, named for Walter W. Heller, former Chairman of the Council of Economic Advisers under Presidents Kennedy and Johnson. One of its most attractive features is its basic simplicity. The Federal Government would distribute to the States each year an amount equal to a specified percentage of the Federal individual income tax base—taxable income reported by all individuals. One variant of the plan would simply divide the total distributable sum among the States according to population. At current levels of taxable income 2 percent would provide $5 billion, or approximately $25 per capita. Some would attach no strings whatsoever to State use of the funds, while others would require that they be spent on a rather wide range of functions or that they not be spent for such generously aided ones as highways.

The plan has several major pluses. Unlike conditional grants-in-aid, its budget-distorting influence would either be offsetting or nonexistent. The amount to be distributed would grow at least as rapidly as the economy as a whole, and probably considerably faster. Thus it would provide a source of revenue that is more likely to keep pace with rising expenditures than existing sources. And a minimum (perhaps equal to the prior year's amount) could be built in to insure against cyclical downswings. The equal per capita form of this unconditional Federal grant would have some equalizing influence among the States because, for example, $25 is a larger proportion of per capita income in Alabama or Mississippi, say, than it is in Connecticut or Delaware.

At several points one may take issue with the Heller plan as thus far presented. But it is a flexible plan which can be modified easily to meet most objections. Clearly, for example, if $5 billion per year (growing at about 6 to 7 percent annually) is thought inadequate, the 2 percent figure can readily be raised to 3, or 4, or any other percent that is consistent with the fiscal position of the Federal Government, its objectives of economic growth and stability, and the needs of State-local governments. Similarly, it would involve only a modest increase in complexity to provide a built-in penalty against those States putting forth relatively little fiscal effort and to provide more interstate equalization of fiscal capacity than would be achieved through equal per capita grants.

Fiscal effort could be taken into account by multiplying the basic per capita figure by the ratio of State-local tax collections in each State as a percentage of income received in the State to the same percentage for the United States as a whole. A State which responded to the receipt of Federal subsidy by cutting its taxes would be penalized by having that subsidy reduced. Similarly, fiscal capacity, as measured by income received in the State, could be built into the formula.

With the suggested modifications, the Heller plan appears to meet the objections that are raised against the alternatives. Under present circumstances, it has far more appeal than a further reduction in Federal taxes, or it may be coupled with a smaller reduction than would otherwise be warranted; it would be likely to meet needs more urgently requiring attention than those that might be met through an equivalent increase in Federal expenditures; and it does not suffer from the disadvantages of expansion of the already unwieldy structure of conditional grants-in-aid.

It is no secret that a Presidential task force headed by Joseph Pechman of the Brookings Institution reported favorably on an undisclosed version of the Heller plan last year and that its report has not been released to the public. Obviously, the plan was not viewed favorably by key Presidential advisers. One can only speculate on the essence of their objections.

Perhaps it was because of reluctance, on the part of Washington bureaucrats, to see Federal funds distributed to the States whose spending they (the bureaucrats) would not supervise. Perhaps it was because influential Washingtonians outside of the Government object to their loss of influence vis-a-vis their counterparts in the State capitals. Some may be reluctant to make more Federal funds available at this time to State officials and legislative bodies whose behavior on civil rights issues has been objectionable.

Others are concerned about the possibility that the larger cities would be shortchanged by the States. Whatever the facts of the matter may be, it seems clear that the Heller plan has yet to be examined on its intrinsic merits.

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FEDERAL-STATE REVENUE SHARING*

BY RICHARD C. WORSNOP

Plans to distribute a fixed percentage of Federal income tax revenue among the States, if and when the Federal budget again produces an annual surplus, may be expected to attract growing attention as State and local revenue needs continue to mount. The current estimate is that annual State and local government expenditures will climb within a decade to $120 billion—about $40 billion more than now. To meet such huge outlays, States and localities will require additional sources of revenue, but new tax sources have virtually disappeared and existing taxes are already burdensome. Access to a share of the Federal Government's tax receipts, therefore, would be a godsend.

The revenue-sharing proposal that has been under discussion recently would supplement existing large Federal aid programs but would differ from them in providing for distribution of funds with few or no strings attached. The plan was first advanced 4½ years ago by Walter W. Heller, who recently resigned as Chairman of the President's Council of Economic Advisers. When Heller, then chairman of the University of Minnesota's Economics Department, suggested in a speech on June 6, 1960, that an agreed share of Federal income tax receipts be diverted to the States, the proposal drew little notice; the country was in a recession and no surplus of Federal revenues was in sight.[1] Since then, the economic picture has considerably brightened. Although Federal expenditures still exceed Federal receipts, economic experts foresee a budgetary surplus within 2 years if tax receipts continue to rise at the present rate of around $6 billion a year and if spending is held down.

In essence, the Heller revenue-sharing proposal is a scheme to ward off recurrent Federal budget surpluses.

Heller rejects the theory, often voiced by conservative economists and Members of Congress, that all excess Federal revenue should be applied to reduction of the national debt. He contends that prolonged piling up of surpluses would produce fiscal drag; that is, it would retard growth of the economy in the absence of full employment.

A report by a presidential study group, submitted in mid-November, showed how the Heller plan might be put into effect.[2] The report was not made public, but it was believed to make four principal recom-

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[1] Two years later, in July 1962, the Governors' conference adopted a resolution proposing that 5 percent of the proceeds of Federal individual income taxes collected in each State be turned back to help finance education within the State.

[2] The study group was headed by Joseph A. Pechman, director of economics at the Brookings Institution.

mendations: (1) That a specified portion—probably 1 or 2 percent—of the proceeds of the Federal individual income tax be turned over to the States every year; (2) that the money be deposited, pending distribution, in a trust fund outside the regular Federal budget; (3) that the States be allowed to use the funds distributed to them in any way they saw fit; and (4) that the funds be distributed in such manner as to give the poorer States somewhat more than they would be entitled to on the basis of Federal taxes paid by their citizens.

Federal and State Reactions to the Proposal

President Johnson endorsed revenue sharing in principle last October 27, but the Heller plan encountered opposition elsewhere in the administration. Secretary of Commerce Luther H. Hodges, interviewed by a Charlotte Observer reporter on November 27, said that "It would be very silly to give money to the States on any unconditional basis." Hodges thought the result would be to make it easier for State governments to avoid facing up to basic responsibilities. Assistant Treasury Secretary Stanley S. Surrey sounded a note of caution in Boston, December 5, when he told the Tax Institute of New England that he was "sure that the President is well aware of all the complexities involved in this proposal and will take them into account before making any (final) decision." It became known 10 days later that the President's decision was negative. At least, he would not recommend adoption of the plan to the 89th Congress when it convenes in January.

Spokesmen for the States had naturally expressed wholehearted support of the Heller proposal. The executive committee of the Governors' conference adopted a resolution on December 1 declaring that "An unfettered proportionate return of Federal tax revenues to State governments * * * would not only enable State governments to accept more responsibility in providing needed services for their citizenry, but would also tend to decrease the alarming trend toward complete Federal domination." Gov. Nelson A. Rockefeller of New York had made the same point in a speech last September 21. In addition to revenue sharing, Rockefeller proposed that collection of "certain Federal excise taxes" be surrendered to the States and that taxpayers be allowed "credits against Federal taxes for payment of certain specified taxes imposed by the States." [8]

Support for revenue sharing has come also from other sources. The National Education Association's legislative commission on December 16 recommended creation of a national educational trust fund to channel increased Federal aid to the States on a no-strings basis. The Commission proposed that as much as $1.25 billion be distributed the first year on the basis of population and need. Proposals of this sort indicate that pressure in behalf of new plans for sharing of Federal revenue with the States is likely to mount. Although the Heller plan may be laid aside now, it is understood that the study group which considered it contemplated in any case, that it would not be put into effect until 1966.

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[8] Address before convention of County Officers Association of the State of New York, Kiamesha Lake, N.Y.

Allocation and Use of the Shared Tax Revenue

Discussion of revenue sharing is centered largely on questions relating to allocation and use of the funds to be distributed. The report submitted to the White House last month was said to recommend that two-thirds of the shared tax revenues be distributed on a per capita basis, and that the remaining one-third go to about a dozen States in especially difficult financial circumstances.

This formula would doubtless encounter opposition in Congress. At present, the District of Columbia and each of 34 States receives a percentage share of total Federal grants-in-aid that is larger than its proportionate contribution to total Federal taxes collected. For example, Alaska gets about 48 cents in grants for every dollar of taxes its people pay to the Federal Government; New Jersey, in contrast, gets back only 5 cents for every tax dollar.[4] Although a State's needs might be generally accepted as one factor to be taken into consideration in allocating shared revenue, Members of Congress from the wealthier States probably would not welcome any appreciable widening of the current gap between what their constituents pay in taxes and what they receive in Federal grants.

Objection might be raised also to distributing Federal funds to the States with no check on how they would be expended. Persons favoring tight Federal supervision over the use of shared revenue tend to distrust State authorities. Without Federal control, the argument goes, some States might spend the money on segregated public housing or on construction of expressways not in conformity with the Federal interstate highway plan. Moreover, fear has been expressed that tax sharing might tend to undermine existing Federal-State programs for health, welfare, and education. To meet these objections, the Federal Government might ban expenditure of shared revenue for such projects as highways but require that it be put to use in certain broad areas of general need.

Many leading economists, including Heller, feel that more trust should be placed in State governments. Much of the shared revenue, they assert, would be spent for education, which already consumes more than one-half of the State and local tax dollar. In that case, the deadlock over Federal aid to education might finally be broken. The States and localities would be able to pay for as well as supervise public education, and perhaps extend aid to church-related schools in addition. Even if States should use shared revenue to reduce State taxes, the consumer would benefit by a lightening of the burden of such regressive imposts as levies on sales and services.

Proposal for State Concession on Tax-Free Bonds

J. A. Livingston, syndicated business columnist, asserted last November 25 that tax sharing should not be all give on the part of the Federal Government and all take on the part of State governments.

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[4] Before World War II, when Federal taxes were much lower, a few States got back in dollar amounts more than all the Federal taxes they paid. Ratios of grants distributed in excess of taxes paid ranged in 1930 from 119 percent in Montana up to 319 percent in Wyoming. A table showing taxes paid and Federal aid received in each State in 1930 may be found in "Federal Subsidies to the States," E.R.R., 1931, vol. 1, p. 13.

The President, Livingston suggested, "should strike a bargain to reform the basic Federal tax structure." The deal he had in mind would require States and municipalities to forego the privilege of issuing tax-exempt securities, which have afforded a tax haven for persons of wealth. If this were done in return for new Federal subsidies, the "flowback to States and municipalities would far exceed the extra cost of floating securities without tax exemption; outstanding securities would not be affected—only those to be issued in the future."

Livingston's proposal is not new. As long ago as 1921, President Harding called for adoption of a constitutional amendment to allow taxation of interest on future governmental issues—Federal, State, and local. Two years later, President Coolidge made the same request. "The existing system," Coolidge said in his annual message to Congress, "permits a large amount of the wealth of the Nation to escape its just burden." He added that "All the wealth of the Nation ought to contribute its fair share to the expenses of the Nation."

Agitation to do away with further issuance of tax-exempt securities died down in 1926, when the maximum Federal income tax rate was reduced to 20 percent. Six years later, however, President Hoover revived the proposal. The Revenue Act of 1932, signed in the depth of the depression, had more than doubled the income tax rates of 1926. "One of the first economic effects of the increases," Hoover declared, was "the retreat of capital into tax-exempt securities and the denudation of industry and commerce of that much available capital."

As before, nothing came of the proposal to make government bonds taxable. A number of politicians and jurists contended that the 16th (income tax) amendment, ratified in 1913, authorized taxation of such securities, because it stated that "The Congress shall have power to lay and collect taxes on income, from whatever source derived." Others insisted, however, that the Federal Government could not tax instrumentalities of the States. Although State and local securities have retained their tax-exempt status, Congress in 1941 made interest on future issues of Federal securities subject to Federal income tax and open to taxation by the States.[5]

Inability of States To Expand Revenue Sources

Tax sharing might save some State and local governments from plunging into bankruptcy. In the 5-year period that began in 1958, State and local tax rates rose twice as fast as Federal tax rates. State and local taxation now is increasing at about double the rate that income is increasing. Since World War II the Federal debt has gone up by only 20 percent while State and local debt has shown a 600-percent increase.

Compounding the financial difficulties of State and local governments is the fact that virtually every source of tax revenue has been tapped. Existing rates, moreover, are in general so high that additional increases invite voter retaliation at election time. In fiscal 1963, for example, the State and local burden in New York State came to $327 a

[5] See "Tax Loopholes," E.R.R., 1950, vol. I, pp. 94–99; also, "Tax Burdens and Tax-Free Securities," E.R.R., 1933 vol. I, pp. 59–78.

person, highest in the country.[6] Only three States—Maine, Massachusetts, and North Dakota—collected less in State and local taxes in fiscal 1963 than in fiscal 1962.

In the 5 fiscal years beginning in 1959, there were 52 increases in State cigarette and tobacco taxes, 42 increases in levies on alcoholic beverages, 18 on general sales, 17 on individual income and 18 on motor fuels. Today, every States taxes motor fuels and alcoholic beverages. All except 16 States tax personal income, all except 13 States tax corporate income and general sales, and all except two tax tobacco products.

Since World War II, State tax activity has followed a predictable pattern. Beginning in 1947 and at 4-year intervals thereafter, the legislatures have passed an extraordinarily large number of laws to tap new tax sources or to raise effective yields from existing levies. The year 1963 was no exception. By the time it ended, no fewer than 35 States legislatures had passed tax laws estimated to increase aggregate annual collections by more than $1 billion.

Tax legislation in 1963, as in previous years, was prompted by a widening gap between State income and expenditure. Only 25 States had managed to achieve balanced budgets in fiscal 1962. Some State legislatures, fearful of voter resistance, declined to introduce new taxes or to raise existing taxes. Instead, they resorted to such expedients as speeding up tax collections, using loan repayments in lieu of tax revenue, and extending "temporary" taxes to get by a little longer without changing the basic tax structure.

Several of the State taxes introduced in 1963 were expected to be of only marginal value. These included levies on billiard tables, storage of sporting equipment, truckers motor fuel purchased out of State, soft-drink bottlers, and colored oleomargarine. As an alternative to increasing taxes, New Hampshire adopted a scheme to raise an estimated $4 million a year from sweepstake horse races, the proceeds to be used for education. Minnesota's income tax law was amended to require every person filing a return to pay a $2 filing fee.

Final reports on tax revenue collected in fiscal 1963, published by the Census Bureau in November, underscored the financial problems confronting State and local governments. The Federal public debt increased by $7.7 billion in fiscal 1963; in the same period, aggregate State and local indebtedness rose by $6.2 billion to a record level of $87.5 billion.

Importance of State Aid to Local Governments

Shared State tax receipts have long been an important source of local government revenue. Since 1942, about 35 cents of every dollar spent by the States has gone to local governments, usually with strings attached. State aid to local governments, aggregating $12.7 billion in fiscal 1966, accounted for about one-fourth of all local revenue.

It is often impossible to associate a particular State payment with a specific financing source. Many State grants-in-aid to localities are drawn from general funds fed by numerous revenue sources. However, contributions to local governments for road construction some-

[6] The national average was $235 per capita.

times come from funds made up exclusively of highway-user revenues, such as taxes on oil and gasoline.

State governments, like the Federal Government, usually distribute shared taxes and grants-in-aid on the basis of a specific formula. For example, a county's share of education aid may depend on its school-age population, enrollment or attendance, or on actual local expenditure. Miles of roads, numbers of registered vehicles, or particular local requirements are usually taken into account in distributing highway funds. So-called per capita aid in New York State, which Governor Rockefeller recently proposed be increased next year from $100 to $200 million, is distributed on a population basis with no strings attached; local authorities have the right to use the funds for any purpose they choose, including reduction of local taxes.

Rapid Growth of Federal Grants-in-Aid

Sharing of Federal revenue with State and local governments is hardly a new idea. Federal payments to States and localities totaled $8.7 billion in fiscal 1963—more than three times the amount the States would receive initially under the Heller plan. Except in the case of interstate highway financing, these payments did not constitute sharing of the proceeds of particular taxes; they were grants-in-aid, financed from general revenues, under which States and localities receive money for specific purposes.

Sharing of Federal Surplus, 1836; Land Grants

The country's first significant venture into revenue-sharing ended in disaster. A law passed in 1836 provided for distribution of a sizable Federal Treasury surplus among the States in proportion to their representation in Congress. The Treasury surplus has been placed in 80 banks, which regarded the deposits as in the nature of permanent loans and had inflated credit accordingly. Calling of the banks' loans—to provide funds to meet the Treasury's demands—helped, together with overstrained credit between the United States and Europe and a drop in the price of cotton, to bring on the panic of 1837. American commerce, finance, and industry did not fully recover until the mid-1840's.

The Morrill Act of 1862 is now regarded as the progenitor of Federal grant-in-aid programs. By that law, the Federal Government gave public lands to the States to aid in developing colleges for the teaching of agricultural and mechanical studies "without excluding other scientific and classical studies and including military tactics." Except for certain restrictions on the spending of principal and on investment, the States were free to sell the donated land in any manner and at any price they wished.

Washington nevertheless attached some strings to the Morrill Act grants. Every land-grant college was required to submit an annual report on its progress, including a record of the cost and results of any improvements or experiments. Furthermore, State Governors had to report annually to Congress on the disposition of funds acquired by sale of donated land. Criticism of the Morrill Act foreshadowed criticism of later grant-in-aid programs. Senator James M. Mason, Demo-

crat, of Virginia, in 1859 denounced the bill which was to become the Morrill Act as "an unconstitutional robbing of the Treasury for the purpose of bribing the States." He added: "In a very short time the whole agricultural interests of the country will be taken out of the hands of the States and [made] subject to the action of Congress."

The Weeks Act of 1911 was another landmark in development of Federal grant-in-aid programs. That law, designed to promote forest fire prevention, required submission of a State plan to the Secretary of Agriculture before Federal funds were disbursed. A decade later, Congress went further. It stipulated that States seeking Federal road-building grants, instituted in 1916, establish highway departments to administer the grants; it stipulated also that such departments have "adequate powers and [be] suitably equipped and organized to discharge to the satisfaction of the Secretary of Agriculture the duties" required by Federal law.

Thus the two cardinal features of Federal grant-in-aid programs had been established by 1921. To become eligible for Federal aid, the States had to conform to certain conditions prescribed by Congress; having conformed, they were required to live up to certain standards of performance if they wished to continue receiving funds from the Government at Washington.

Changes in Federal and State Fiscal Situations

Despite passage of such legislation as the Morrill and Weeks Acts, Federal grants accounted for only a tiny fraction of State and local spending up to the 1930's. As late as 1929, State and local governments spent $7.7 billion, or about 2½ times as much as did the Federal Government. Only about $150 million of the billions expended by States and localities came from Federal grant money.

Before World War I, State and local revenues were supplied primarily by taxation of real and personal property, while the Federal Government had relied mainly on receipts from customs duties and excises. Introduction of the income tax on a permanent basis in 1913 opened up a rich new source of Federal revenue, but initial rates on both individual and corporation income were set at low levels. From 1913 through 1916, Federal income tax receipts aggregated only $622 million.

American entry into the European war in April 1917 gave rise to extraordinary fiscal demands which were met in large part by boosting income tax rates. Revenue from this source in 1917 alone came to $2.8 billion,[7] or almost five times as much as had been collected in the 4 preceding years combined. Income tax collections soared in 1918 to $4.3 billion, a record not matched thereafter until 1941. The high tax rates necessitated by World War I were scaled down when peace returned; by 1924, Federal income tax receipts were down to only $1.6 billion.

State and local governments found themselves unable to cope with the problems caused by the economic depression of the 1930's. Property tax revenue, mainstay of State and local finance, fell off because of widespread payments delinquency; at the same time, demands for relief and welfare services grew increasingly urgent. As a result, the

[7] Including excess-profits tax receipts.

Federal Government was forced to support functions that had traditionally been the exclusive responsibility of States and localities.

Federal grants to State and local governments rose by 650 percent in 11 years, from $147 million in 1930 to $945 million in 1940. Most of the additional grant money was earmarked for welfare, relief, and public works. Under the Social Security Act of 1935, the Federal Government extended matching grants to the States for old-age assistance, aid to the blind, aid to dependent and crippled children, and maternal and child health.

Substantial increases were made in other types of Federal aid to the States. Highway grants mounted from $75 million in 1936 to $260 million in 1938; some $122 million of the latter amount came from emergency relief appropriations. Public Works Administration grants to State and local governments totaled $176 million in 1938. Annual grants for agricultural extension work and vocational education rose during the depression decade, while the Housing Act of 1937 authorized annual subsidies to local housing authorities.[8]

Despite the rise in overall Federal spending and Federal grants-in-aid during the 1930's, State and local governments continued to spend more than the National Government. As recently as 1940, State and local expenditures aggregated $11.2 billion, compared with Federal expenditures of $10.1 billion. American entry into World War II the following year reversed this balance; in 1944 the Federal Government spent $100.5 billion, or 10 times as much as all State and local governments combined.

From the end of the war in 1945 until 1950, State and local revenues rose along with a general expansion of the economy. Rapidly mounting property values brought a corresponding increase in local tax receipts. Many State levies imposed during the depression years became productive revenue sources, especially general sales and income taxes. Total State expenditures doubled between 1946 and 1950, and surpluses accumulated during the war evaporated as the backlog of needs was met and demands for new services arose.[9]

Tripling of Federal Grants-in-Aid in Past Decade

Although State and local spending has increased every year since the war, it has failed to keep pace with needs generated by population growth and changing technology. Urban areas, underrepresented in most State legislatures, have often complained that they receive considerably less in State aid than they contribute in State taxes. Accordingly, city officials have come to rely on Washington for help on such undertakings as slum clearance, urban renewal, air pollution control, airport construction, mass transportation, and metropolitan planning.[10]

Federal contributions to these and other State and local projects have resulted in a tripling of grants-in-aid in the past decade. Grants-in aid aggregated $2.9 billion in fiscal 1953, or 8.6 percent of combined State and local revenues. In fiscal 1963, the latest year for which fig-

[8] See "Public Housing in War on Poverty," E.R.R., 1964 vol. II, pp. 523–540.
[9] See "State and Local Taxation," E.R.R., 1963 vol. I, pp. 107–124.
[10] See "Reapportionment Struggle," E.R.R., 1964 vol. II, pp. 717–719.

ures are available, Federal grants totaled $8.7 billion, or 11.6 percent of State and local revenues. Even with this massive transfusion of Federal aid, State and local governments have found it impossible to make ends meet. State and local indebtedness almost tripled between 1953 and 1963, rising from $33.8 to $87.5 billion. Since 1958, State and local debt has risen by $29 billion; the much larger Federal debt increased by the same amount in that period.

Diversity of Federal Government's Aid Programs

Federal grant-in-aid programs have grown so large that they have been described as constituting virtually a fourth sector of government. The annual report of the Secretary of the Treasury listed 65 different programs under which States and localities received grants from the Federal Government in fiscal 1963. There were, in addition, 52 programs under which Federal payments went directly to individuals within the States. Altogether, Federal grants to governments and individuals in 1963 came to $10.9 billion.

The biggest single grant program, accounting for one-third of all Federal aid to State and local governments in fiscal 1963, was the interstate highway program; total payments were $3 billion.[11] The 13 next most important programs, listed in declining order of expenditure, were public assistance, unemployment insurance, public health (research and services), food distribution, education, agricultural conservation, National Guard, public and rural housing and urban renewal, conservation practices, veterans' benefits, agricultural extension work, vocational rehabilitation, and child care. Each of these broad categories of aid included two or more component programs.

State and local finances, 1951–63 [1]

[Dollar amounts in millions]

Year	Expenditures	Revenues	Federal grants	Percent of revenue	Debt
1953	$32,937	$33,411	$2,870	8.6	$33,782
1954	36,607	35,386	2,966	8.4	38,931
1955	40,375	37,619	3,131	8.3	44,267
1956	43,152	41,692	3,335	8.0	48,868
1957	47,553	45,929	3,843	8.4	53,039
1958	53,712	49,262	4,865	9.9	58,187
1959	58,572	53,972	6,377	11.8	64,110
1960	60,999	60,277	6,974	11.6	69,955
1961	67,023	64,531	7,131	11.1	75,023
1962	70,547	69,492	7,871	11.3	81,278
1963	75,760	75,317	8,722	11.6	87,451

[1] Fiscal years.

Source: Bureau of the Census.

Formulas for allocating Federal grants vary both within and among programs. Public assistance grants, according to the Department of Health, Education, and Welfare, are "intended to provide the highest percentages of Federal participation to the low-income States, which generally have relatively large proportions of needy people and make relatively low assistance payments." Such programs in effect redistribute income from high-income to low-income States.

[11] See "Progress of the Road Program," E.R.R., 1960 vol. II, pp. 645–662.

Other types of Federal aid, such as veterans' readjustment benefits, are distributed among the States largely according to their respective populations. Still another type of grant program tends to benefit certain States more than others because of regional differences. Agricultural conservation programs, for example, help Southern and Midwestern States more than those in other regions. On the other hand, heavily populated States are the principal recipients of urban renewal and public housing assistance.

A multitude of factors are taken into account in disbursing Federal grant money. For example, funds for primary, secondary, and urban roads (the so-called ABC system) are distributed as follows: one-third in the ratio of a State's rural population to total U.S. rural population in 1940; one-third in the ratio of a State's area to total U.S. area; one-third in the ratio of a State's rural delivery and star route mileage to all such mileage in the country. The allocation formula for interstate highway funds is even more complex. From fiscal 1957 through fiscal 1959, one-half of all interstate highway money was distributed according to population, and one-half according to the foregoing formula for ABC roads. The interstate formula has since been revised to take account of new cost estimates. States must match Federal grants for ABC roads dollar for dollar, but the Federal Government pays 90 percent of the cost of the Interstate System.

Resentment at Federal Mixing in State Affairs

Many State officials have expressed apprehension over spreading Federal control of publicly financed programs at all levels of Government. Although the standards set forth in Federal grant-in-aid programs have served generally to upgrade the quality of State and local services, the feeling persists that valuable tax money is lost on the roundtrip journey to and from Washington. Senator Harry Flood Byrd, Democrat of Virginia, an outspoken critic of waste in Federal spending, has described grants-in-aid as "programs through which the Federal Government collects money from taxpayers in the respective States, clips it for 15 to 20 percent in overhead expenses, and then passes it back to the States on Federal formula with the strings of centralized government attached." [12]

It is sometimes said that Federal grant money does not always reach its intended destination. S. David Adler, superintendent of schools in Newton, N.J., last winter described alleged shortcomings of Federal aid to education as follows:

> The great pity of the National Defense Education Act and similar grants-in-aid is that the well administered school district which already has realized, through local effort, a fairly satisfactory expenditure level and a fairly satisfactory facilities base can provide the required secretarial services and administrative time requirements which are a prerequisite, enabling them to take advantage of the grants-in-aid.
>
> The poorly administered, inadequately equipped districts do not or cannot take advantage of this situation. We believe you will find that it is the wealthier, better organized, better equipped,

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[12] Remarks on Senate floor, June 5, 1962.

and better housed school districts which have received the bulk of all Federal aid.[13]

On the other hand, Mayor William W. Maier, of Milwaukee, contends that "low-income States already have the advantage of lower wage and materials costs for given amounts of aid," so that "to further emphasize low-income areas in distributing such aids merely gives a double equalizing effect to aid programs." It is asserted also that States will sometimes apply for grants that they do not need so as to prevent other States from getting a disproportionate share of Federal funds.

Staying Power of Federal Aid Programs

To replace present Federal grant-in-aid programs with State and local programs financed through shared tax revenue would be so difficult that it probably would not be attempted. Senator Edmund S. Muskie, Democrat, of Maine, chairman of the Senate Government Operations Subcommittee on Intergovernmental Relations, pointed out in an interview last winter that Federal programs tend, "once enacted, to go on and on, no matter how useful they may be, without a meaningful or consistent congressional reexamination of their effectiveness as instruments of intergovernmental cooperation." Muskie added that "The record shows that only 14 such programs have ever been terminated, in spite of numerous efforts in Congress to terminate or redirect particular ones." [14]

The Senator proposed a 5-year limit on the life of all grant-in-aid programs to insure periodic review of achievements under the programs. He suggested that it might be found, upon reexamination by Congress, that certain programs had outlived their usefulness and could therefore be terminated; others might be deemed in need of expansion.

It is usually difficult, however, to determine whether a grant-in-aid program ought to be eliminated. Persons engaged in administering a program acquire a vested interest in keeping it alive, and over the years their arguments have survived congressional scrutiny. One example is the program of Federal aid to vocational education, now in its 47th year. The fact that this program is still in operation proves that it is a failure, asserts James Rennie, Maryland budget officer, "or else we would not need to continue to encourage its establishment." Rennie is of opinion that both the Area Redevelopment Act of 1961 and the Manpower Training Act of 1962 "seem to have the same purpose"—alleviating unemployment. "It would seem either one or the other could be eliminated. but this has not happened." [15]

Despite their stated aversion to Federal supervision, State and local governments are loath to see a grant-in-aid program die. Federal grants provide a reliable source of income which States and localities would be hard put to duplicate. Moreover, the wages paid to administrative employees of grant programs sometimes constitute a sizable fraction of the total payroll in a community.

Results of the presidential and congressional elections last November 3 seemed to show, among other things, that pledges to curtail or elim-

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[13] Local Leaders Tire of Federal Ties, *Nation's Business*, February 1964, p. 76.
[14] Ibid., p. 78.
[15] Ibid., p. 87.

inate Federal activities attract few votes. Senator Barry M. Goldwater, of Arizona, the Republican presidential nominee, evidently frightened voters in the upper South by suggesting that the Tennessee Valley Authority, or at least a part of that extensive public project, be sold to private interests. One reason for the defeat of Representative Bruce Alger, Republican, of Texas, was said to have been his unrelenting opposition to Federal aid for his district.

A more striking demonstration of the importance of Federal money to States and localities came on November 19, when Defense Secretary Robert S. McNamara announced that 95 military installations in 33 States would be phased out of existence. Members of Congress from the affected States, many of whom had championed economy in government, denounced McNamara and promised to fight to keep the installations open. Governor Rockfeller predicted that closing of the Brooklyn Navy Yard would bring "unemployment, suffering, and hardship" to its 10,600 civilian employees.

OVERLAPPING OF TAXES AND SPENDING AT ALL LEVELS

Soaring demand for public services of all kinds has resulted in overlapping of taxation and spending at every level of government. For almost half a century, the Federal Government has relied on the income tax for the largest part of its revenue, while State governments have relied increasingly—particularly since the 1930's—on sales and liquor as well as income taxes; property taxes continued to be an important source of local revenue. There was a rough division of responsibility also on the expenditure side; most Federal spending after 1945 was for defense and foreign activities, most State spending for highways and higher education, and most local spending for elementary and high school education.

More recently, the boundaries have become blurred. Property taxes now account, on the average, for only 43 cents of the local revenue dollar, as against 54 cents in 1940. Local governments have made up the difference by introducing various service charges and nonproperty taxes. No fewer than 13 States permit local sales taxes, and cities and counties have not hesitated to take advantage of this opportunity to obtain additional revenue.

Voters in Shelby County, Tenn., which includes Memphis, this year approved a local sales tax of 1 percent; the State government already had a sales tax of 3 percent. Virtually all cities and counties in California collect sales taxes, and the list of Illinois and Mississippi communities which do so is constantly growing. Virginia is unusual in that cities may impose a sales tax but counties may not. As a result, a number of financially hard-pressed cities in the State have avoided the sales tax for fear of losing retail business to surrounding counties.

When authorized to tax income, cities have jumped at the chance. About 80 cities in Ohio collect income taxes, although the State itself does not. Most municipal income taxes affect only payroll earnings of residents and of nonresidents whose jobs are within the city limits. A majority of States, however, prohibit local governments from duplicating any State tax; hence many cities and urban counties have no recourse to levies on income.

A study group appointed by President Eisenhower 7 years ago suggested a way to curtail overlapping of Federal and State taxes and expenditures. In a report made public December 5, 1957, the Joint Federal-State Action Committee urged that the States assume sole responsibility for four programs then costing the Federal Government about $105 million a year—vocational education, construction of waste treatment facilities, urban renewal planning, and repair of public facilities damaged in natural disasters. The committee proposed that the Federal Government in return reduce the tax on local telephone service for 5 years from 10 to 6 percent in States levying a like 4 percent tax of their own. At the end of the 5-year period, the Federal tax would be reduced throughout the country to 6 percent and the States would be entirely on their own.

The proposals got a cool reception in Congress. Critics pointed out that the plan failed to consider differences in financial capacity among the States. To meet this objection, the committee put forward in September 1958 a revised plan calling for maintenance of the Federal telephone tax at 7 percent during the 5-year transition period, with revenue from the additional 1 percent to be divided among 31 lower income States. As in the original plan, the Federal tax would be reduced to 6 percent at the end of 5 years.

Again, the committee's recommendations made no headway in Congress. The Heller plan, far greater in scope, may be expected to remain in the discussion stage until such time as it may be given vigorous administration support. The record seems to show that Members of Congress are reluctant to let control of any tax revenue, or source of tax revenue, slip from their hands even if the States which they represent would benefit in the process.

NO-STRINGS AID FOR THE STATES?*

BY ALAN L. OTTEN and CHARLES B. SEIB

As the Federal Government's programs have grown in size and importance, so has popular uneasiness over the increasing centralization of power in Washington. The proposals advanced in President Johnson's state of the Union message, by increasing Federal involvement in a wide range of national problems, run the risk of aggravating another old problem—the relationship between Washington and the State and local governments. To counterbalance the trend toward greater Federal intervention, a plan to strengthen the role of the States by turning back to them a small portion of U.S. Treasury tax receipts was suggested last spring by Walter Heller, then Chairman of the President's Council of Economic Advisers.

The plan was the object of detailed study by a Presidential task force headed by Joseph Pechman, a Brookings Institution economist. The task-force report has never been made public, but its general outlines have become well known. Each year the Federal Government would set aside in a special trust fund an amount equal to 1 percent of all personal income subject to tax. For example, in calendar 1965 this income will be about $250 billion, so the fund would start with about $2.5 billion, or approximately one-quarter the amount Washington now grants through specific programs to State and local governments. This amount, of course, would increase as taxable income rises. The money would be distributed automatically to the States, generally in proportion to population but with some adjustments to the needs of the individual States. Each State could spend the money as it pleased, except for one or two general prohibitions, such as those against outlays for highways or public buildings. The radical part of the Heller-Pechman proposal is this relative freedom from Federal controls.

In the past decade, Federal aid has more than tripled, from $3.1 billion in fiscal 1955 to over $10.5 billion this fiscal year, or about 14 percent of State and local general revenues. These grants now issue from a dozen different Federal agencies under nearly 70 programs, ranging from help for airports and low-cost housing to educational television and control of venereal disease. Most of them go to the States, a few directly to cities or counties. Some require no State or local matching funds, others anywhere from 10 to 75 percent. Some go on a straight population basis, others under a needs formula, and most under a combination of all three. The Heller-Pechman plan is above all an attempt to help States and local communities without expanding Federal powers and responsibilities. Washington has never before seriously considered such a solution.

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*Reprinted from *The Reporter*, Jan. 28, 1965, vol. 32, pp. 33–35.

To be sure, some Federal moneys were turned back to the States with no strings attached in 1836. Sales of public land were running at a high clip, a business boom had customs receipts soaring, and the Federal Government was covering all its needs and had paid off its debts. The Jacksonians accordingly voted to distribute a $37-million surplus in four installments to the States. Three had been made when the panic of 1837 wiped out the remaining surplus.

The Task-Force Leak

In recent years the problem has come under study both in and out of Washington. The Eisenhower administration offered to yield some tax revenues to the States if they would take over some spending programs, but Congress balked at giving up the taxes and the States rebelled at assuming responsibility for the spending. Heller, who had learned at first hand of State problems as a fiscal adviser to Secretary of Agriculture Orville Freeman when Freeman was Governor of Minnesota, began casting around for some new approach soon after becoming Chairman of the Council on Economic Advisers in 1961. Gradually, he and some of his economist friends came to favor the "no strings" grants.

The plan seemed an effective compromise between the advocates of more government spending and those who want stronger States. Or looking at it from the other end, it was likely to offend the planning-minded less than tax cuts and the States' righters less than new direct and tightly controlled Federal grants. The Pechman task force left its organizational meeting with President Johnson under orders to study all possible ways of helping the States and cities but with the clear impression that the President was chiefly interested in Heller's plan. This belief was strengthened when the platform adopted at the Democratic convention in August argued that "Consideration should be given to the development of fiscal policies which would provide revenue sources to hard-pressed State and local governments. . . ."

During the campaign, Barry Goldwater called for a portion of Federal taxes to be turned over each year without restriction to the States and cities, but he was merely reaffirming a longstanding conservative proposal that the various Federal aid programs be replaced by a single grant, while Heller wanted the no-strings grant to be in addition to existing programs. In the final days of the campaign, the White House issued a position paper that promised "intensive study . . . of methods of channeling Federal revenue to States and localities which will reinforce their independence while enlarging their capacity to serve their citizens." This was commonly interpreted as a Johnson endorsement of the Heller plan, and at that point some proponent of the plan leaked the outline of the task-force recommendations to the New York *Times*, along with the inference that the President had subscribed to them.

The tactic boomeranged. The President, increasingly sensitive about news leaks that he does not himself generate, was annoyed. Opponents in and out of the administration, who had been wondering just how seriously to take the plan, decided to take it very seriously and jumped into action with a variety of objections. The ensuing controversy

ended when the President, at a mid-December background session for newsmen, declared that premature disclosure of the task-force recommendations had generated such opposition that he had decided to put the plan aside at least for a year.

In the meantime, the plan will continue to have the support of a small band of government officials and academicians, chiefly undoctrinaire liberals, and, for obvious reasons, the Conference of State Governors. Their argument is simple: the entire Federal-State-local system is being threatened by the inability of the State and local governments to meet their skyrocketing financial obligations. Their general spending has soared from $11 billion in 1946 to $64.8 billion in 1963—many times the percentage growth in Federal outlays. The total could easily top $100 billion by 1970.

General revenues of the States and localities, including Federal aid, have had a hard time keeping up. Debt had risen from $15.9 billion in June 1946, to $87.5 billion last June. Their income, heavily dependent on local property taxes and State sales taxes, doesn't rise as rapidly with economic growth as does the income-tax-oriented Federal system. Many State constitutions bar income taxes; one State already has a 5 percent sales tax, and 3 percent and 4 percent sales taxes are common. Attempts to raise existing tax rates or levy new taxes are politically risky. Moreover, State and local economic-development officials are pessimistic about the number of new industries that might be driven away by higher tax rates.

Federal tax receipts, on the other hand, are rising by about $6 billion a year. In fact, some economists worry because they are increasing so fast and taking so much spending money out of circulation that they may become a "fiscal drag" on the economy and cut off the current boom. These economists suggest with Heller that some of the Federal revenues be put back into circulation by giving them to the States and cities.

Opposition Arguments

By far the most vocal opponents of this approach are those who fear the scheme would offer Congress a pretext to reject new or expanded specific grant programs or even to cut back existing ones. Many of these critics work for such grant-oriented Departments as Labor, Commerce, Agriculture, and Health, Education, and Welfare. But many more are to be found outside Government in organized labor, education, welfare, and health groups.

The influential National Education Association is fearful that the plan could be used as an argument against specific aid-to-education legislation. As an official of a leading welfare organization put it: "I can see it now—we go up to the Hill to get more money for our programs and the Congressmen tell us, 'Why, you don't need that. Mr. Heller is going to take care of all that.' "

The intense hostility of these groups reflects, in part, their high hopes for the new Congress. "This is a defeatist plan—the kind you come up with after you've tried everything else and gotten nowhere," one labor lobbyist argued. "You don't come up with it at a time like this, when your chances of getting everything you've always wanted are better than ever."

Many administration officials continue to tell these groups, as they always have, that direct Federal spending or tightly controlled Federal grants is the surest way of securing their goals. They contend that State and local goverments are too apt to use the money for the wrong purposes—for padded State payrolls instead of housing, for graft and payoffs instead of mental health, for industrial development projects in the South to lure plants from the North instead of for education. Many areas, they charge, will merely use the Washington money to finance a cut in local tax rates.

"With the conservative nature of the [Oregon] Legislature," said Representative Edith Green, Democrat, Oregon, "and with the control of the lower house in the hands of Republicans who have never been willing to invest wisely in education . . . I would be even less than enthusiastic" about turning money back to the States without tight Federal strings. A union leader was even blunter: "The labor movement has had years of experience with State legislatures, and we just don't trust them. Practically every bit of progress we've made in the last 30 years we've made at the Federal level."

Quite a few union officials also fear that without control, funds returned to States and cities wouldn't be spent under the Federal wage, overtime, and fair employment practices standards governing most grant programs. Civil-rights groups fear that, directly or indirectly, southern Governors might use the funds to finance segregated schools.

Many local officials wonder how much of the new Federal funds would actually be passed along to them from the States. The National League of Cities (until recently the American Municipal Association), for example, representing officials of over 13,000 communities, asked the President either to send large chunks of the grant money straight back to the localities or to earmark it for State distribution to local governments.

Most business associations tend to oppose the plan, preferring that any revenue not spent by Congress for essential Federal programs be returned to individuals and companies in the form of tax cuts. The Catholic Church joined the ranks of the opposition for still another reason. No State now makes general grants to parochial schools, and most have specific constitutional bars against such aid. On the other hand, the chances of getting aid through a Federal education bill have been improving.

Proponents' Answers

In the face of such intense organized opposition, the plan's supporters are avoiding a public debate for the time being. Private talks with them, however, produce a detailed rebuttal that runs along these lines:

First of all, they do not want Congress to use the plan as an excuse to block specific new grant programs for education, mass transit, and the like, and do not see why it should. There is plenty of Federal money to go around, they maintain, to permit $2 billion or so of Federal excise cuts, $3 billion or so of extra expending for expanding the programs already voted by Congress, and several billions for new programs—as well as for their own plan for aiding State and local governments.

In any case, they argue, many States and cities are now so financially pressed that they will find it hard to avail themselves of new Federal grant programs that require local matching funds. This was a major argument advanced by the executive committee of the Governors' Conference in its endorsement of the Heller plan. Few States, for example, have given any sign of voting matching funds for the job-retraining program, even though this will become a requirement on July 1, if Federal funds are to continue to be available; thus far, the program has been entirely Federal.

Moreover, many officials believe that the traditional grant programs have induced many States and cities to overspend in order to qualify for extra Federal funds. For example, they claim that many States build unneeded interstate highways because they get nine Federal dollars for each one of their own. Or they boost old-age assistance payments higher than they can afford because they get proportionately more Federal dollars. Poorer States in particular feel obliged to put a disproportionate share of their funds into Federally matched programs such as highways and airports rather than into such unaided programs as fire and police protection.

Backers of the Heller plan believe that the States would be less liable to waste the no-strings aid. They argue that reapportionment will soon produce legislatures better prepared to take care of urban and suburban needs, and that even now most legislatures are using every cent they can find for worthy causes such as education and mental health.

"At a meeting of Governors and local officials a few months ago, I asked what they'd do if they suddenly got a big chunk of money to spend as they wished," one Washington advocate of the new plan reported. "Every one of them, and there were many from the South, said they'd spend it on schools—that this is where the pressure is."

To the objection that some States might use the new Federal funds as a device to permit tax cuts, the plan's backers reply that spending pressures are just too great. At the most, they predict, extra Federal money might be used to avoid or delay tax increases, thereby substituting dollars raised from a progressive Federal income tax for those raised through regressive State and local sales and property taxes.

Even the staunchest advocates of the Heller plan concede that a few Southern States might try to use the money for segregated schools and other segregated facilities. But they hope the new Civil Rights Act would prevent this. They would also be willing to incorporate some special civil-rights safeguards and guarantees that the usual overtime, prevailing-wage, and other labor standards apply to any use of the new Federal funds.

The Heller-Pechman plan, though not a part of President Johnson's program, will at least be discussed as Congress takes up various aspects of his wide-ranging legislative proposals. Perhaps after the special-interest groups have had a crack at getting what they want from the new Congress, after more reapportionment has been accomplished, and after business groups see that increasing Federal revenues are not going into tax cuts but into extra Federal spending, there will be less opposition to the plan. It then may be seen for what it is: a fresh approach to a basic problem of American politics. "Do you want to have stronger States or don't you?" asks Heller. "Frankly, I do. It's just that simple."

THE SHARE-THE-TAX-REVENUE PLAN*

BY ROBERT L. HEILBRONER

Now up, now down; a few weeks ago said to be at the head of the administration's proposals, now rumored to be in the ashcan; but sooner or later certain to command national attention and debate is that rarest of rarities—a really new idea in domestic economic policy. Very simply, it is a plan for the Federal Government to help State governments by regularly and systematically turning over to them a fixed portion of Federal tax revenues to be used as the States see fit.

Since the Federal Government is likely to have embarrassingly large tax revenues in the future and since the States will unquestionably have embarrassingly small ones; and since the Federal Government is inhibited, for various reasons, from embarking on large-scale new expenditure programs, whereas the States have so much to do they don't know what to do first, one would think that the tax-sharing plan would command the happy assent of all. Instead, a mere first glimpse of the plan has already sparked one of the sharpest debates in many years—a debate that arises from profoundly differing conceptions of American government.

The idea of tax sharing has been evolving for some time. Last June, before his retirement as Chairman of the Council of Economic Advisers, Walter Heller had already formulated the main outlines of a plan to channel Federal revenues to the States, and had deeply interested the President in it. Thereafter, during the summer and early fall, a task force of economists, under the chairmanship of Joseph A. Pechman of the Brookings Institution, refined the details of the Heller plan. Now their report is at the White House, where, it is said, it is being kept under wraps for the moment, perhaps to be unveiled in 1966.

Although the actual details of the task force report are still secret, there is general agreement that four recommendations constitute its main substance:

1. Each year a certain percentage of Federal income-tax revenues would be set aside for State distribution. If the initial set-aside were 1 percent of income-tax revenues, the tax share for the States would come to about $2.5 billion in this current year. Over the years ahead, as tax revenues grow, this sum will increase; by 1970 it is estimated to be roughly $3.5 billion. (Congress could, of course, increase the percentage of set-aside as well.)

2. The funds earmarked for the States would thereupon be credited to a trust account, before being handed over to the States themselves. This has the advantage of keeping the entire transaction out of the

*Reprinted from *New York Times Sunday Magazine*, Dec. 27, 1964.

Federal budget, a perfectly legitimate maneuver, since the money is not being "spent" by the Federal Government but only transferred by it to the State governments who will indeed spend it. At the same time, needless to say, the trust device is a nice way of keeping up Government expenditures—even though they are recorded officially at the State and local level—without swelling the politically sensitive Federal budget. (Lest this be thought an insidious innovation of the administration, it should be noted that the trust fund is an old established financial mechanism, widely used for State-aid programs such as highway construction.)

3. The plan thereupon envisages the trust fund being turned over to the States with little or no limitation on its use. If any "strings" at all are to be attached, they are thought of as being of the most general nature, such as a broad prohibition on use of the funds for highway projects, or their consignment to unspecified "education or welfare" purposes.

4. Finally, the tax-sharing plan would help the poorer States somewhat more than the richer ones. Most of the trust fund would be distributed on a per capita basis, but not all of it. A portion of the fund—perhaps even as much as 25 percent—would be reserved for use by the poorer States only. Thus a State like New York, with a relatively high income level would indirectly contribute more to the trust fund than it would get back by way of tax-sharing, whereas a poor State like West Virginia would be a relative gainer through the plan. For New York, the tax-sharing plan would mean additional receipts of about $200 million, or about 7 percent of its budget expenditures; for West Virginia, receipts of perhaps $3.5 million, or 9 percent of its 1964 budget.

On its face, the tax-sharing plan seems to be a brilliant political move—and, one would think, very much in the typical Johnson style—a move to woo the States and to enhance the Federal Government's prestige at the same time. But while there may be considerable political mileage in it, much more than politics lies behind the idea. To Walter Heller, or to the Pechman task force, the rationale for the tax-sharing approach lies in two very big problems to which the plan offers at least partial answers.

The first of these is the already large, awesomely mounting total of State and local needs. In part the trouble here stems from our "baby boom" of the late 1940's. What was then only a perambulator parade has now swept through our elementary and high schools, and is in the process of inundating our colleges. As a result, State and local expenditures on education have exploded. Three billion dollars in 1945, $7 billion in 1950, $11 billion in 1955, $22 billion today and probably around $50 billion by 1975.

But education is not the only source of vastly expanded State and local expenditures. As urban and suburban areas have grown and population densities have increased, the cost of maintaining health and sanitation, recreation and transportation, welfare and simple public order has increased disproportionately. According to the National Planning Association, total spending by the States, towns and cities, already over $55 billion, will rise in another 10 years to almost $155 billion.

Yet, while the States look forward with uneasy certainty to an unprecedented need for public expenditure, they cannot look with anything like equal assurance to revenues large enough to match their needs. In the main the States rely on property and sales taxes for their revenues (only 7 percent of all State revenues come from income levels), and raising these taxes is a difficult business.

Property taxes are traditionally fought by the real-estate interests, whose power at State and local levels is very great, while sales taxes are not only politically unpopular with the electorate but are already bumping up against the tacitly accepted ceiling of 5 percent in many States. At the same time the States are loath to impose or increase income taxes, for fear these will drive individuals or businesses across State lines.

To be sure, the States have not yet scraped the bottom of their tax barrels, and necessity has a way of bucking up legislators' courage. There is, in addition, the possibility of additional borrowing, particularly for educational outlays. But given the inertia and frictions of local politics, and the fact that State debts have climbed from $34 to $90 billion in the last 10 years, the prospects of finding revenues adequate to fast-growing needs are not bright. The squeeze, already noticeable in too many State educational and welfare budgets, will certainly get worse, unless new sources of income are developed.

This need of the States, then, is the first of the problems the Heller plan may help solve. The second is the so-called "fiscal drag" that arises from the powerful suction exerted by Federal income taxes.

As individual incomes increase, along with economic growth, income tax liabilities rise even faster, since individuals typically move up into higher tax brackets. Thus, the result of every sustained rise is gross national product is an even faster accumulation of income taxes in the hands of the Federal Government.

This in turn poses a substantial problem for further growth. For unless the Federal Government, having sucked taxes out of the Nation's pocketbooks, now returns this money to the Nation's pocketbooks by spending it, the growing hoard of income-tax receipts will act to slow down—perhaps even to halt—further economic expansion.

In this dilemma, two possibilities suggest themselves. First, the Government might try another tax cut, thereby diminishing the pull of its suction machine, and incidentally giving the States a chance to impose their own taxes in lieu of lowered Federal taxes. Second, the problem of drag could be overcome simply by spending the additional tax revenues each year as it comes in.

Unhappily, both courses have their difficulties. A tax cut, if it is used by large numbers of families as a means of augmenting their savings, will not fully overcome the drag problem. In addition, there is the consideration that the new private spending created by a tax cut is not likely to reach into the corners of the economy that most need help. Finally, as one experienced observer has stated, it is difficult for States to move against the tide of a national tax cut, even if they would like to raise State levies to fill the gap left by lowered Federal taxes.

Hence, many economists would prefer the opposite tack—spending the added tax revenues through new Federal programs. But the hitch

here is one of political realism. However, much larger new Federal spending programs may commend themselves to liberal economists, myself included, it is uncertain whether programs of the dimensions required would find congressional—or even widespread public—approval today. Our arms budget is gradually declining, thereby releasing funds that might be used for welfare purposes. But judging by what seems to be the fiscally conservative tenor of the times, it will not be easy to shift funds wholesale from arms to housing, education, or antipoverty programs.

Hence, the likelihood of spending for those purposes the $6 million per year additional tax revenues that are projected for the years ahead seems very remote. On the contrary, the prospect of rising revenues in the face of falling defense needs is sure to rouse every-popular demands for paying back the national debt, or for constitutional limitations on the income tax, or for other nightmarish favorites of populist-conservative economics.

Therefore, the double relevance of the Heller plan. Not only does tax-sharing come to the aid of the hard-pressed States with the only large-scale source of funds available in the near future, but at the same time it provides a way of removing fiscal drag—while, as a bonus, it simultaneously dampens demands to pay back the debt or do away with the income tax. As a creamy blend of short-run expediency and long-run public interest, the idea seems hard to beat.

Understandably, the Heller plan has the vigorous support of many State Governors, including Rockefeller of New York and Brown of California. Congressmen are less willing to commit themselves publicly so early in the game, although many middle-of-the-road Republicans and Democrats seem favorably inclined (indeed, some moderate Republicans wish they had made it a public issue first).

As to where President Johnson stands, it is hard to say. Publicly committed to helping the States with their financial problems, he has first leaked favorable and then unfavorable comments on the Heller plan. At the moment it appears that the plan will be allowed to languish for a while. Yet it seems a good bet that sooner or later someone will discover its merits. If it isn't President Johnson, it might very well be one of the moderate Republicans.

Meanwhile, however, opposition has broken out from an unexpected source. The first denunciations of the Heller plan have begun to come in—from the side of labor and from some of the more articulate spokesmen for the liberal point of view.

Much of their dissatisfaction is focused on what all admit to be the weakest part of the present scheme—the very large area of freedom left to the States in disposing of their Federal shares. Liberals and labor representatives alike are aghast at the thought of handing over Federal revenues for the support of Mississippi's school or law-enforcement system.

Although they are not against aiding some State programs, they want Federal help to be carefully limited to specific ends, as is the case with the $10 billion of existing State-aid programs. In addition, many liberals are afraid that the States will merely use their Federal tax receipts as an excuse to lighten States taxes, thereby getting us more or less nowhere.

Proponents of the plan have counters to these arguments. While admitting that some strings are inevitable, they point out that the grant-in-aid technique, now spread over 80 different programs, is so unwieldy that it threatens to become unworkable. Hence, while agreeing with general strings (such as prohibition of the use of funds for segregated educational activities), they strongly oppose adding to the bureaucratic load of finely defined grants.

In addition, they point out, the Supreme Court's decisions on segregation and reapportionment provide new safeguards on the States' use of funds. And as for the argument that the States will merely use their Federal revenues to slough off their own taxes, proponents of the plan assert that pressures are so great on the States that, much as they might like to, they will not be able to cut back their own taxes.

But it is not really on these questions that the debate grows sharp. Lurking in the background and giving animus to both sides of the issue is a much deeper and less easily settled question—the role that State government should play in shaping the economic and political future.

Basically, the liberal opposition does not trust the States to play a creative role in that future. As Christopher Jencks puts it in the New Republic, "Even a casual survey of 20th century politics suggests that the major pillars of the status quo have been the 50 States. Conversely, the major force for innovation and progress has been the Federal Government."

If by the 20th century we mean since 1930, there is much to support Jencks' view (before then the States were often in the vanguard of social reform). Admittedly, however, in recent years the very words State and local government have given rise to dreary associations of mediocrity, timidity, and graft, whereas Federal Government has conjured up at least the hope of intelligence, imagination, and effective administration.

Yet, on second thought, the stereotypes blur. For, without denying the generally inferior level of State performance compared with Federal, it is impossible to tar all the States with the same brush. As Jencks himself mentions, there are the pioneering efforts of California in establishing 2-year community colleges (and in erecting an impressive statewide network of university campuses); and to this we can add the bold educational policies of Wisconsin; the massive State-city planning of Boston, Pittsburgh, New Haven; the growing sophistication of antidelinquency programs (compare New York's efforts with those of 10 and 20 years ago); the growth of interstate compacts on water use or transportation; the stepping-up of antipollution programs.

"With some exceptions, largely in the Southern and Southwestern States," says Prof. James Maxwell, an authority on these matters, "the States have faced up with considerable courage to the problems that have beset them." As a crude index of their willingness to act, we might note that State and local expenditures in recent years have been rising twice as fast as the gross national product.

Therefore, it seems a bit premature to write off the States as hopeless, particularly when so many of their faults—low morale, sluggish

performance, lack of publicity—are remediable, at least to some degree, by the additional funds. To be sure, it is doubtful that the States will themselves initiate and organize the large-scale programs that are necessary to attack some of the major problems of the late 1960's, such as chronic poverty, urban decay or technological unemployment. But then there is no reason why the Federal Government cannot continue to exercise leadership in these critical areas.

Meanwhile, someone must pick up the bill for the Nation's schooling, for its basic welfare services, for its humdrum but desperately important sanitation and health needs, for its police and fire departments, its public parks and beaches, its roads and streets. Unless we want all these functions ultimately centered in Washington, the States and localities must have the wherewithal to provide these services independently on a generous scale.

It may be, of course, that it is too late, that the States are already nothing but an outmoded framework imposed on us by the past, and that we should not now bend our energies to salvaging what is unsalvageable. But again it may not be too late. If the 20th century preaches the lesson of economic centralism, it also teaches the virtues of political decentralism. The effort to strengthen the States at least seems worth the try. As Walter Heller says, "If we are serious about the idea of creative federalism, now is the time to do something constructive about it."

Whether during this Congress or not, it seems likely that we shall very soon have to make up our minds as to how serious we are.

STRENGTHENING THE FEDERAL SYSTEM—THE CASE FOR REVENUE SHARING*

BY Representative MELVIN R. LAIRD (R., Wisc.)

Mr. LAIRD. Mr. Speaker, the first weeks of the 90th Congress have been particularly gratifying to those of us who advocate a strengtened and better balanced federal system.

Both in the House and in the Senate, many proposals have been introduced which fall into the broad category of revenue sharing. Whether we talk of flat percentage rebates with no Federal strings, or general bloc grants or tax credit proposals, we are talking of revenue sharing.

I have today introduced a revised and updated version of my own bill (H.R. 784), which was first introduced in 1958 and at the beginning of each Congress since then.

Some hestiation has marked my introduction of this revised revenue-sharing bill (H.R. 5450). This hesitation stems from the deep-held belief that the best possible formula for an effective and worthy revenue-sharing bill must await the full and detailed hearings that only the committees of Congress can provide.

Nevertheless, this is the second half of the 20th century. America has grown more complex; the world has grown more troubled; and the time for talk of better solutions to move our country forward has long since passed.

The growing public impatience with the ineffective "solutions" of the past 30 years demands bold new action today.

The growing public support for the principle of revenue sharing as the better way for a modern America to do things demands we move forward now.

It is for this reason that I have today introduced what I consider to be a basically sound proposal for implementing revenue sharing in this second half of the 20th century.

This new bill is similar in many respects to H.R. 4070 which was introduced recently by my distinguished colleague, the gentleman from New York [Mr. Goodell]. However, my proposal calls for returning to the States a straight 5 percent of the Federal personal income tax. The Goodell proposal escalates to 5 percent in 4 years instead of immediately. The 5 percent under the Laird bill is distributed to the States

*Excerpts of speeches of Hon. Melvin R. Laird of Wisconsin, in the House of Representatives, February 15, March 13, and April 10, 1967.

with no strings attached. An optional provision is made—similar to the Goodell proposal—for the use of 5 percent of the sum allocated to each State for improving State administrative machinery. Beyond that, in my bill no provision is made for a required pass through to local political subdivisions. I should emphasize that this in no way applies my opposition to such a provision. It merely reflects my belief that the best distribution formula can only be devised after the legislative discussion process has heard from various representatives of different governmental levels. More will be said on this later.

The most important distinction between my bill and that introduced by the distinguished gentleman from New York is my provision for a Federal income tax credit for State and local taxes paid by individuals. This provision, which begins by permitting a 10 percent Federal income tax credit for individuals paying State and local taxes of all types, gradually and smoothly extends to 40 percent after the fourth year of the plan. As credit is extended by the Federal Government for State and local taxes paid, it will free up local resources permitting the State and local authorities to increase their tax levels to meet needed State and local problems.

With the exception of these primary distinctions, my proposal is similar to that of the gentleman from New York [Mr. Goodell].

Mr. Speaker, I hope that we will be successful in convincing a Democratic-controlled Congress to schedule hearings on the Laird bill, the Goodell bill, or some general revenue-sharing bill. I hope also that the testimony of our Governors, our mayors, our county supervisors, and representatives from other political subdivisions within our States and from the academic community will lead to perfecting amendments in the formulas and provisions suggested so far.

In my view, no one person or no committee has yet devised the best plan for sharing Federal revenues with the States. The elements involved are so complex, the ramifications so broad that representatives from all of the affected elements within our society must be heard before a final, equitable formula is devised.

In my remarks today, Mr. Speaker, I will touch on some of the problems yet to be resolved by the appropriate committees of Congress in developing the most effective program of revenue sharing.

Let no one, however, mistake these remarks as an indication of my own uncertainty about the merits of revenue sharing.

Nothing could be further from the truth.

The measure I have introduced today, the Goodell proposal of January 30, or several other revenue-sharing measures that could be cited here—if put into effect today in place of existing Federal grant-in-aid programs—would do a far more effective job in solving America's problems than many of the specialized Federal programs operating today.

The difference is that we on this side of the aisle prefer to recognize that no individual, no party, no organization has a monopoly on good

ideas or good procedures. Had this been recognized in the 89th Congress, when so many pieces of legislation were rubberstamped through a docile, undeliberative Congress, with no opportunities for perfecting amendments, the public disaffection with the operation of those programs might not exist today.

I refer, of course, to the Elementary and Secondary Education Act, to the so-called antipoverty program, to the Appalachia regional development bill, and to a host of others which could have been improved and their subsequent operation thereby enhanced.

We on this side of the aisle seek and welcome suggestions that will improve and make more effective the programs we advocate.

It is in this spirit that my remarks are intended.

Mr. Speaker, my remarks today are designed to serve several purposes. First, I hope to bring together many of the proposals that have been offered and to outline briefly the history and the great promise of revenue sharing.

Second, an attempt will be made to develop the case for early action by this Congress on revenue-sharing legislation.

Third, a brief and necessarily sketchy look will be taken at the record amassed by the operation of specialized Federal grant-in-aid programs. An attempt will be made to show why revenue sharing would be a far better way for Americans to do things than the way of the great planned society.

Fourth, appendices will be attached to my remarks which hopefully will assist academics and others who are interested in researching the various proposals and the various studies that have already appeared on this subject.

Fifth, an explanation of the Laird bill will be attached as appendix No. 1, together with the text of the Laird bill for those who might wish to study its provisions.

Historical Background

FEDERAL LEVEL SUPPORT

Mr. Speaker, on January 30, my distinguished colleague, the gentleman from New York [Mr. Goodell] introduced a Federal Tax-Sharing Act—H.R. 4070. He was joined by 31 colleagues from our side of the aisle who introduced similar proposals.

This keen expression of interest on the part of the minority Members of this body reflects a nationwide awareness that new solutions must be found for the problems of our society and new methods of financing those solutions must supersede the old, demonstrably unworkable solutions of prior years.

In the other body, similar expressions of interest have been manifest. The House-Senate joint Republican leadership, as a significant element of the Republican coordinating committee, unanimously supported the task force report of last March endorsing revenue sharing.

In addition to the support expressed by all the members of the Senate Republican leadership, the senior Senator from New York, Senator Javits introduced this year S. 482 while the senior Senator from Pennsylvania, Senator Scott, introduced another Federal revenue-sharing bill—S. 694.

Mr. Speaker, I am especially pleased to note that some members of the majority party have also recognized the wisdom of revenue sharing and the need to revitalize our State and local institutions. They have joined in endorsing revenue sharing through proposals of their own or through public statements endorsing the concept.

On January 19, for example, the distinguished gentleman from Florida [Mr. Fascell] introduced H.R. 3127 which provides for the unconditional sharing of certain Federal tax revenues with the States.

At the conclusion of my remarks, I will include a list of all revenue-sharing legislation introduced thus far in this first session of the 90th Congress, and all measures introduced in the 89th Congress as appendix No. 2.

STATE AND LOCAL SUPPORT

At the State and local level there has also been considerable and growing interest in revenue sharing. The National Conference of State Legislative Leaders, the National Council of Mayors, and many similar organizations have spoken out. They have either endorsed revenue sharing in formal resolutions or have indicated, individually and jointly, their marked interest in this method of restoring State and local responsibility.

The National Governors' Association 2 years ago and again this year overwhelmingly supported revenue sharing in formal resolutions. If memory serves, all 50 Governors signaled their approval 2 years ago and only two failed to approve the resolution this year.

Our Republican Governors have been in the forefront of this battle in recent years. My own Governor in Wisconsin, Warren Knowles, recently reaffirmed his support for revenue sharing and stated the case for its implementation. His policy statement will be inserted as appendix No. 3. In a December 1966, speech, and in his inaugural address last month, the new Governor of Pennsylvania, Raymond Shafer, called for a revenue-sharing program of $3 billion with no Federal strings, to be distributed among the States on the basis of population.

Various Republican groups have prepared excellent research reports on revenue sharing. I cite the following as examples and ask unanimous consent that a more detailed bibliography on revenue sharing be inserted as appendix No. 4.

"General Aid for States and Localities," a policy paper prepared by Richard P. Nathan for the Planning and Research Committee of the House Republican Conference—August 1, 1966. This report formed the basis of the Goodell proposal and major elements of my own; "Financing the Future of Federalism: the Case for Revenue-Sharing," a report issued by the Republican coordinating committee on March

28, 1966; and "Government for Tomorrow," a research report issued jointly by the Republican Governors' Association and the Ripon Society in July 1965.

In addition to general endorsement of the concept of revenue sharing and the issuance of research reports, some instances of formal action have begun at the State levels.

For example, the Iowa Legislature last month enacted a resolution in support of the Laird revenue-sharing bill. Other States have instituted action of a similar nature. The Governor of Texas, John Connally, in his 1967 inaugural address called for the Texas Legislature to initiate an amendment to the Constitution of the United States. The Connally proposal would provide for a sharing of Federal corporate and personal income taxes with the States.

All of these efforts, Mr. Speaker, indicate the growing awareness of the need for a new approach to Federal-State financial relationships.

ACADEMIC SUPPORT

Within academic circles, the battle concerning revenue sharing has been waged for a number of years. As a matter of fact, it goes back at least to the early 1950's when Prof. Roger A. Freeman—now with the Hoover Institution on War, Revolution, and Peace at Stanford University—was affiliated with the U.S. Commission on Intergovernmental Relations—Kestnbaum Commission. In 1954–55, Dr. Freeman unsuccessfully advocated revenue sharing.

In recent years, Dr. Walter W. Heller has been credited with originating the idea shortly before he retired as Chairman of the President's Council of Economic Advisers. The Heller proposal in its original form was designed to eliminate what he called the fiscal drag which the new economics could foresee as a result of governmental income rising faster than anticipated governmental expenditures. Of course, Vietnam, coupled with the continued rapid expansion of Federal grant-in-aid programs intervened to absorb any fiscal drag which could be expected for the foreseeable future.

Heller's proposal has been modified somewhat over the years. In his most recent volume, he disavowed his earlier position that grants would be given to the States only during times of fiscal surplus. He now states that they would be given to the States whether there was a budget surplus or a deficit, or even if granting them to the States would mean creating a deficit:

> The "very nature of the proposal calls for them (the States) to be first in line for their modest share of the income tax, even if it means that the Federal Government has to bear the brunt of periodic deficit financing." [1]

That the Heller plan is basically different from the Goodell and Laird proposals was reemphasized at this morning's hearings on the

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[1] Walter W. Heller, *New Dimensions of Political Economy,* Cambridge, Mass., Harvard University Press, 1966, p. 151.

Economic Report of the President before the Joint Economic Committee. In those hearings, Dr. Heller reaffirmed his support of revenue sharing, but as a supplement to, rather than a substitute for, existing grant-in-aid programs.

Another academic proponent of revenue sharing is Dr. Joseph A. Pechman who chaired the special Presidential task force in the fall of 1964. The recommendations of this task force and its full report unfortunately have never been made public by the Johnson administration..

The reasons for withholding this information are difficult to understand.

Even without an official release, however, the press was able to ferret out much of the information contained in the report. Thus, in a page 1 story in the New York Times of October 28, 1964, Edwin L. Dale, Jr., announced that the task force had recommended in favor of a revenue-sharing scheme. The basic provisions of the task force recommendations were also reprinted in the Dale article.

Mr. Pechman has not changed his attitude toward Federal revenue sharing during the course of the last 2 years. Recently, before a special meeting of an advisory task force of the U.S. Chamber of Commerce, he still recommended in favor of revenue sharing. The Pechman plan, like the Heller plan, would provide revenue sharing in addition to the current grant-in-aid programs provided by the Federal Government. At this same meeting of the U.S. Chamber, Woodrow Ginsburg, the research director of the AFL–CIO's Industrial Union Department, took what was ostensibly the other side of the position; that is, he opposed Federal revenue sharing with the States. But, as Frank C. Porter pointed out in a story in the Washington Post on January 22, 1967, it seemed that Pechman had made the proposal almost palatable even to the labor union movement.

PUBLIC SUPPORT

In case anyone should believe that support for revenue sharing is not widespread among the general American public, I would call his attention to a recent Gallup poll. The results of this poll, released on January 1, 1967, show that 70 percent of the American public favors revenue sharings, while only 18 percent oppose it. The details of the poll show that this support is overwhelming in all regions, by all age categories, by occupational groupings, and by every other meaningful measure.

Mr. Speaker, this same poll reveals that twice as many people believe that the State governments can spend the tax dollar more wisely than the Federal Government.

It is also interesting to note that the American citizenry is much more apprehensive over a possible threat from big government than from big labor or from big business.

Mr. Speaker, I include the results of this poll in the Record at this point in my remarks:

Gallup Poll

Tax sharing plan

Question." It has been suggested that 3 percent of the money which Washington collects in Federal income taxes be returned to the States and local governments to be used by these State and local governments as they see fit. Do you favor or oppose this idea?"

[In percent]

	January 1967		
	Favor	Oppose	No opinion
National	70	18	12
Sex:			
Men	70	20	10
Women	69	16	15
Race:			
White	71	19	10
Nonwhite	X	X	X
Education:			
College	68	27	5
High school	71	18	11
Grade school	69	10	21
Occupation:			
Professional and business	69	23	8
White collar	65	24	11
Farmers	83	13	4
Manual	70	15	15
Age:			
21 to 29 years	66	20	14
30 to 49 years	70	20	10
50 and over	71	14	15
Religion:			
Protestant	72	16	12
Catholic	66	19	15
Jewish	X	X	X
Politics:			
Republican	72	20	8
Democrat	69	15	16
Independent	69	22	9
Region:			
East	64	20	16
Midwest	73	21	6
South	74	11	15
West	65	20	15
Income:			
$10,000 and over	68	25	7
$7,000 and over	70	21	9
$5,000 to $6,999	76	14	10
$3,000 to $4,999	67	15	18
Under $3,000	65	15	20
Community size:			
1,000,000 and over	57	20	23
500,000 and over	62	20	18
50,000 to 49,999	71	21	8
2,500 to 49,999	68	21	11
Under 2,500, rural	79	11	10

Government spending

Question. "Which do you think spends the taxpayer's dollar more wisely—the State government or the Federal Government?"

[In percent]

	January 1967			
	State	Federal	Neither	No opinion
National	49	18	17	16
Sex:				
Men	52	18	19	11
Women	47	16	16	21
Race:				
White	52	16	18	14
Nonwhite	X	X	X	X
Education:				
College	57	19	18	6
High school	51	17	16	16
Grade school	40	18	18	24
Occupation:				
Professional and business	56	15	17	12
White collar	52	20	16	12
Farmers	59	6	20	15
Manual	45	21	16	18
Age:				
21 to 29 years	49	23	14	14
30 to 49 years	49	17	17	17
50 and over	49	15	19	17
Religion:				
Protestant	52	15	16	17
Catholic	44	24	18	14
Jewish	X	X	X	X
Politics:				
Republican	60	11	17	12
Democrat	46	21	14	19
Independent	44	19	22	15
Region:				
East	37	27	19	17
Midwest	54	16	18	12
South	58	10	14	18
West	46	16	19	19
Income:				
$10,000 and over	53	18	18	11
$7,000 and over	50	18	19	13
$5,000 to $6,999	54	19	14	13
$3,000 to $4,999	44	16	16	24
Under $3,000	44	15	18	23
Community size:				
1,000,000 and over	36	24	19	21
500,000 and over	41	23	17	19
50,000 to 499,999	46	19	18	17
2,500 to 49,999	57	13	14	16
Under 2,500, rural	56	12	19	13

Biggest threat to Nation

Question. "In your opinion which of the following do you think will be the biggest threat to the country in the future—big business, big labor, or big government?"

[In percent]

	January 1967			
	Big business	Big labor	Big government	Don't know
National	14	21	49	16
Sex:				
Men	17	23	49	11
Women	12	20	48	20
Race:				
White	13	22	51	14
Nonwhite	X	X	X	X
Education:				
College	9	25	59	7
High school	14	22	48	16
Grade school	18	17	42	23
Occupation:				
Professional and business	10	26	55	9
White collar	11	20	58	11
Farmers	28	12	49	11
Manual	16	18	46	20
Age:				
21 to 29 years	8	16	61	15
30 to 49 years	15	23	47	15
50 and over	16	23	44	17
Religion:				
Protestant	14	18	52	16
Catholic	15	29	42	14
Jewish	X	X	X	X
Politics:				
Republican	7	23	60	10
Democrat	19	20	42	19
Independent	13	22	50	15
Region:				
East	17	28	36	19
Midwest	17	22	51	10
South	8	11	61	20
West	14	23	47	16
Income:				
$10,000 and over	11	28	50	11
$7,000 and over	14	26	49	11
$5,000 to $6,999	14	19	51	16
$3,000 to $4,999	15	18	40	27
Under $3,000	17	16	49	18
Community size:				
1,000,000 and over	17	23	38	22
500,000 and over	17	21	43	19
50,000 to 499,999	11	27	51	11
2,500 to 49,999	12	18	54	16
Under 2,500, rural	15	18	51	16

Mr. Speaker, it is obvious from this brief and sketchy history that there is no significant element of our society to whom the principle of tax sharing is unacceptable. The recent Gallup poll indicated that 70 percent of the American people approve and support the principle of revenue sharing with the States.

A great many prominent public officials from Governors to State legislative leaders to representatives of every political subdivision within our States have signaled their approval.

Many Members of Congress, a Presidential task force, and eminent economists and academicians, including Prof. Arthur Burns—former Chairman of President Eisenhower's Council of Economic Advisers—have likewise endorsed revenue sharing.

With such eminent support across the broad spectrum of our society, what better case needs to be made for early action by the 90th Congress on revenue-sharing legislation?

Certainly those who argue that the Congress should have the opportunity to vote up or down legislation that is supported by large segments of our population have seldom seen a more clear-cut example of such a bill.

THE CASE FOR REVENUE SHARING

Mr. Speaker, for the benefit of those who would like to review the arguments that have compelled such widespread support across America for revenue sharing, I will attempt to outline briefly some major elements in the case for revenue sharing.

The case for revenue sharing can be approached in two ways of course. One can look at the proposal itself on its own merits. Or one can look at the proposal as it relates to existing programs of specialized Federal aids.

A little of both will be touched upon in my remarks.

DEFINING THE PROBLEM

First, of course, we must try to define the problem.

Today, our leaders in Washington who control both the executive branch and the legislative branch have chosen two terms to describe their approach to government. One term is the "Great Society." The other is "creative federalism."

Everybody, of course, wants a "great society" in America. Most of us believe Americans have already created the greatest society in the history of mankind though most would also agree that much remains to be done.

Both our present leaders and those of us who disagree with their approach believe that the way to the greater society is through "creative federalism."

In other words, everybody would like to see "creative federalism" work.

The problem, however, is that different proponents of different philosophies of government define "creative federalism" in different ways.

Those who presently guide our domestic and foreign destinies in Washington view creative federalism in such a way that the Federal Government, in effect, makes the ultimate judgments and establishes the governing criteria.

Advocates of the present approach see the role of the Federal Government as the ultimate problem solver of America's ills.

Another way of putting it, perhaps, is that creative federalism as viewed by its present stewards in Washington is an attempt to substitute the activity of bureaucracy for the creativity of the individual.

They seem to be saying: "You can't depend on local people to do a needed job. Rather, the Federal Government must develop, establish, and administer a Federal solution to specific problems."

I do not agree with this, and I do not think that the leaders in our

legislatures and statehouses would accept this indictment of their abilities to cope with the problems they face in their respective States.

Unfortunately, however, many Americans believe that this indictment is justified. They believe that State officials have lost faith in their own abilities to cope with our increasingly complex society. This is not my belief.

To be candid, though, when one studies the problems superficially, there is much truth in the statement that local people and local or State governments cannot be depended upon to do the needed jobs.

It is certainly a fact of life that many of the ills of our society are not being solved at the local and State level. Many of our cities are in terrible shape; poverty, unemployment and crime do run rampant in many areas; city slums are a disgrace; social problems do abound; transportation is in a mess.

Who among us needs a catalog of these ills? We are all familiar with the problems. We are all searching for the best solutions to those problems.

THE CRUCIAL QUESTION

In my view, the crucial question is not being asked today.

That question is not whether these problems are being solved at the local and State level.

The crucial question is, Why are they not being solved at the State or community level?

Proponents of the "creative federalism" I have described above believe that they remain unsolved because the States and local people cannot solve them. I disagree.

Those at the State level and those at the local and community level can very definitely solve these problems. They do not solve them largely because they lack the resources to tackle them properly.

LACK OF RESOURCES

The mayors of our cities who testified before the Ribicoff Senate subcommittee last session made this abundantly clear. Every Governor in these United States would certainly back up this claim.

The simple fact is that the resources are lacking at the State level precisely because the Federal Government has dried them up.

They can impose a sales tax, a property tax, and a very minimal income tax. But, in each case, the amount of taxes that can be collected from the citizens or the corporations of each State are the dregs of what is left over after what almost amounts to a confiscatory tax rate has been exacted by the Federal Government.

No tables are needed, no diagrams, no documentation.

There may be different and varying problems in the respective States with regard to other matters. But the Federal Government has given all States at least one thing in common: a general lack of tax revenue sources.

We can at least agree on two basics: The problems exist; the States lack the resources to tackle them effectively.

THE PRESENT SOLUTION

What then is the solution? Proponents of today's "creative federalism" seek to solve these problems with special or categorical Federal grant-in-aid programs. The Department of Health, Education, and Welfare alone put out a book containing some 527 pages. It is entitled "Grants-in-Aid and Other Financial Assistance Programs Administered by the U.S. Department of Health, Education, and Welfare."

This 527-page book merely lists and describes briefly the grant-in-aid programs administered by this single department of the Federal Government.

In all, there are 190 programs listed. They account for expenditures of some $7 billion annually which represents less than half of the more than $14 billion in annual Federal expenditures on such programs administered by the Federal Government.

Each of these programs has its own administrator and its own army or regiment or platoon of personnel. Many of the programs have field personnel in regional offices and many, of course, have personnel in every State.

Recently the Office of Education prepared a table for the use of congressional offices. This table outlines the programs available from that bureau alone. There are 112 separate grant-in-aid categories in this table. I include this table as appendix No. 5 at the conclusion of my remarks.

The simplest way I know of bringing home to the average person in practically any city in these United States just how deeply the Federal Government is involved in one way or another in his community and State is to refer him to the telephone book. The other day, I checked the telephone directory in Milwaukee and in Wausau, Wis., under the heading U.S. Government. In Milwaukee, I found 240 separate telephone listings for the Federal Government and only 166 for the State government. In Wausau the ratio was 24 Federal to 11 State listings.

Again, I would be saying nothing new if I attempted to catalog the list of Federal requirements, the redtape involved in obtaining approval, the man-years spent by State officials in connection with these programs, the interagency and intraprogram rivalries that exist among Federal programs, and so on.

In my own State of Wisconsin, it has been estimated that our taxpayers contribute $1.46 toward the cost of grant-in-aid programs for every grant-in-aid dollar they get back from the Federal Government.

A good part of that 46 cents goes for overhead and administrative costs of the Federal Government. The rest goes to the poorer States through an equalization formula.

Wisconsin would not complain, California would not complain, Illinois would not complain, Massachusetts would not complain—no State would complain if the categorical grant-in-aid programs administered by the Federal Government were accomplishing the job.

THE PROBLEM

But are they? The present approach has been tried and tested in increasing degrees for a great many years. In 10 years, Federal grant-in-aid expenditures have increased by $10 billion from approximately $4 billion in 1956 to more than $14 billion in 1966.

This approach obviously is not working.

Why? Well, one reason is the lack of adequate resources at the Federal level. Many people overlook the fact that the aggregate number of dollars needed to do an effective job in all of the areas in which the Federal Government operates would require many times the amount contained in the total annual Federal budget.

A major problem is the reluctance of this administration in particular to set any meaningful priorities among its hundreds of programs.

The result is that too few dollars chase too many goals. Revenue sharing with no strings would permit the States to select the most pressing priority problems and devote larger, more effective amounts to deal with them.

THE GRANT-IN-AID RECORD [2]

Let us look for a moment at some of the experiences under these specialized Federal aid programs.

Just a few weeks ago, the Economic Development Administration proudly announced a grant of $32,430 to rescue from poverty a seven-county Oklahoma area with 131,000 people within its boundaries. On a per capita basis, this amounts to 25 cents per person.

True, those counties which embrace the Kiamichi Mountains are economically distressed.

But the grant—not by any means unusual in amount in proportion to population—serves to illustrate that vast as the Federal grant-in-aid appropriations are, such programs cover so many objectives for so many people over so large an area that they turn out to be surprisingly inadequate in detail and often a definite deterrent to progress.

This "Kiamichi Economic Development District" grant is not conceived to be the complete answer to the economic sluggishness measured in the area. It is "planning money," a dollop of funds to enable the counties to run surveys and see what they can do to be eligible for other Federal grants-in-aid—often for further planning. And the planning usually consists largely of determining what other grants—for water and sewer systems, roads, recreational development, and so forth—may be sought.

At this point, after the "planning grant" has been utilized—if the area's experience is typical—it will find that the agency to which it applies has more applications for dollars than it has dollars to dispense—at ratios of up to 12 to 1.

This often retards progress and impedes local initiative in the field of problem solving for a very simple and understandable reason. So long as the hope for "Federal money" exists, local politicians will find it suicidal to propose bond issues for immediately needed improvements, and they will be delayed. A share of the blame must go to these circumstances created by Federal Government programs for municipal

[2] See also Melvin R. Laird, *The End of an Era*, N.A.M. Reports, Feb. 20, 1967.

pollution of streams and other justifiably condemned "ills" of our society.

The EDA program is typical of many. The much-heralded demonstration cities program will yield only $11 million for the rest of the 1967 fiscal year—to be passed in razor-sliced planning grants to as many as a hundred avid cities—of the 300 to 1,000 the Housing and Urban Development Department expects will apply for them.

Program after program, according to the available figures, has bitten off a bigger problem than it can chew. For example, the U.S. Conference of Mayors and the National Association of Housing & Redevelopment Officials, last summer arrived at the conclusion that 800 cities with urban renewal programs would need $7.4 billion to operate through June 30, 1969, and only about $2.3 billion would be forthcoming.

Cities and counties, States, and qualified citizens associations, all wait for such funds to solve their problems in the manner of prospective heirs anticipating the deaths of rich uncles, meanwhile ignoring other possibilities of improving their lots in life.

Federal funds are, apparently, addictive, and great cities allow projects well within their means to become stalled once Federal money is embedded in the plans and the thinking.

Currently, the magnificent arch which features St. Louis' redeveloped Mississippi riverfront is incomplete because a couple of million dollars of Federal money which was expected did not arrive. Rebukes have been conveyed to Washington in a tone which suggests that a golden arch desired by St. Louis is quite naturally a financial obligation of all U.S. taxpayers.

And the tone is a justifiable response to the expectations that have been created by such a vast proliferation of Federal grant-in-aid programs whose promises—of necessity—must always outstrip the possibilities of fulfillment.

It should be noted that if St. Louis has such an idea, it certainly did not originate there. It should also be noted that the citizens of St. Louis have paid considerably toward the ornamentation of other cities—as indeed have all taxpayers from whatever community in the United States. It is almost as if, in a variation of the old economic model, we had all agreed to pay for each other's laundry and so relieve ourselves of burden.

In some notable cases, funds that have been committed by Washington apparently have been hung up somewhere in the process of dispensing them. Governor Rockefeller, of New York, in his inaugural address took occasion to scold Washington for this.

And signs are that the Federal money will become even tighter.

Washington, D.C., recently heard details of a 9-year renewal program proposal which would cost $3 billion, and other cities have comparable ambitions. Representatives of 14,000 communities meeting in Las Vegas—the National League of Cities—in December agreed on a common goal—more Federal funds. The National Planning Association has estimated the cost of renewing all our cities at $2 trillion plus.

This, of course, is only one phase of the grant-in-aid programs. The current total—more than $15 billion a year—provides for many other kinds of programs, all of which seems to find their appropriations on the skimpy side, too.

According to U.S. News & World Report for December 5, 1966, a program for colleges brought applications from 550 schools for a total of $32 million. The agency awarded $5 million to 225 of them.

Last year, the Wall Street Journal reported that Congress appropriated $100 million for one water program, and communities promptly applied under the program for $3 billion.

In the last session my colleague, the gentleman from New York [Mr. Conable], noted that the Economic Development Administration had requested $326 million and received $640 million in applications, with the fiscal year far from ended. The Interior Department had $263 million for water pollution control grants, and applications for $881 million.

Many of us in Congress have cautioned local officials in our areas about the imbalance between funds requested of Federal agencies and the funds available for distribution. This we do in an effort to enable local officials to plan more realistically and to avoid serious disappointments and difficulties.

Mr. Speaker, another example centered on the question of storm sewers. In the Housing Act of 1965 a total of $200 million per year was authorized for matching—50-percent—grants for the construction of local sewer systems. This program proved to be very popular with many communities, and applications began to pour in to the Department of Housing and Urban Development.

So what did the administration do? They cut the amount appropriated under this program from $200 to $100 million. This was done, in spite of the fact that over $4 billion in applications—40 times the amount of funds available—have been received. I understand that it is now the policy of the Department of Housing and Urban Development to advise against the filing of applications for this program as it is clear that funds for new applications will not be available.

An interesting sidelight on this sewer construction program was provided in my own congressional district. An editorial in my hometown paper, the Marshfield News-Herald, recently pointed out that the Department of Housing and Urban Development in response to an inquiry indicated that the city of Stevens Point will not qualify for Federal aid for its storm sewer expansion program now or in the immediate future. It went on to say:

> While Stevens Point can't get money to separate storm from sanitary sewers, Racine County is quite certain it will qualify for Federal aid for its first county golf course.

Can anyone honestly say that the States could not run programs in the general areas of health, welfare, education, and economic development better than the Federal Government has been doing?

Mr. Speaker, the growing disillusionment with Federal specialized grants-in-aid is becoming apparent all across our land at every level of government and in every type of activity concerned with public or community problems.

It is my own strong belief that the era of the specialized grant-in-aid, conceived, designed, and administered from Washington, is coming to an end. I think these examples prove that it is a second best method of dealing with the increasingly complex problems of modern America.

Its largely unlamented end will be hastened as more and more Americans come to realize that there are better, more effective, and more efficient ways for Americans to do things in this second half of the 20th century.

NEED FOR PRIORITIES

Mr. Speaker, still another aspect of this whole question has to do with whether the Congress should devote so much of its time to these largely local issues in light of its many other major concerns.

With evolving international relationships, with our various commitments to over 100 countries abroad, with the growing threat of nuclear proliferation, with weapon sophistication which was undreamed of in former times, and with the "space race" well underway, can the Congress and the President—the only parties in the Nation who have the power to decide these issues—can they instead spend their time deciding how many million dollars should be spent for golf course construction?

Once again, I must ask: Where is our sense of priorities? Does it not make sense that those governmental bodies which are closest to the people can better decide these local questions while simultaneously relieving the Congress of much of this burden and enabling it to concentrate more of its time and attention on the pressing international issues of the age?

THE PROBLEMS INCREASE

Mr. Speaker, Americans are already aware of the sorry record amassed in the Federal grant-in-aid programs.

With more than 200 categorical grant-in-aid programs expending more than $14 billion annually, they see our problem persist and grow:

Crime continues to rise.

Education continues to be inadequate.

Slums continue to exist and grow worse.

More Americans go on the welfare rolls.

Government services on the State and local level continue to be underfinanced and in many cases ineffective.

In short, the quality of American life across the board—despite the vast and growing Federal commitment—is deteriorating.

ANOTHER REASON

They ask why? In addition to the reasons cited above, another is that Milwaukee has different problems than San Francisco and Columbus, Ohio has different problems than Wassau, Wis. The Watts area in Los Angeles faces different problems than Harlem in New York.

In one city the unemployed—even if they have the skills—have a difficult time getting and keeping jobs because of poor transportation, as the McCone report pointed out in its study of Watts.

In another city, the problem may be lack of jobs rather than adequate transportation.

In still another city, there are plenty of jobs, but the unemployed lack the skills to fill those jobs.

And on and on.

All of these communities, as you well know, have the same general problems in the sense that there is poverty, unemployment, inadequate education and job training, perhaps, and other problems of the same general nature.

But the solution to poverty in one community may very well be a training program, but in another it might more appropriately be correction of the transportation problem.

OVERSIMPLIFIED SOLUTION

Proponents of the categorical or special Federal grant-in-aid solution may mean well—in fact, I am convinced they do—but in reality, they are merely looking at the superficial manifestation of the problems that exist.

In point of fact, they are the ones who oversimplify both the problems and their solutions.

What the proponents of special Federal aids fail to realize is that a general solution devised in Washington may very well help the situation in Milwaukee, but that same solution may compound the problem in New York. The checkered record of the antipoverty program during the past 2 years is a prime example of this.

Mr. Speaker, I am a Republican who believes in the Republican formula that the best way to attack problems is by working first through the institutions and the levels of government that are closest to the people who face these problems.

I am at the same time a realist who recognizes that this formula is unworkable in the context of today's American society with its emphasis on Federal solutions to local problems.

What we must do is alter one of the key elements in American society—not through massive change—but through a simple change.

We must rechannel our Nation's resources into a much more balanced equation that neither robs Uncle Sam of the revenues he needs for proper Federal functions nor continues to deprive State and local governments of the financial resources they need to face and meet the challenges that lie ahead.

TAX CREDITS

Another aspect of this whole idea of Federal-State fiscal relationships centers around the concept of tax credits. Tax credits differ from tax deductions in that credits are applied to an individual's net obligation, and are then treated as if they were a cash payment on the net tax obligation of the individual.

As a further encouragement to State and local governmental units, I call the attention of my colleagues to section 13 of my new bill which provides for a 40-percent tax credit for all State and local taxes paid. This means that, for every dollar of local or State tax paid by the individual, be it sales tax, State or city income tax, property tax, and so forth—in other words, any tax for which a deduction is now granted—a tax credit would be granted.

The only exception, a relatively minor one, deals with foreign taxes owed by U.S. citizens. This is excluded as it would mean renegotiating all of our present tax treaties in effect with foreign countries.

The tax credit provision of my bill begins at the 10-percent level. It then increases by 10 percent a year for the next 3 years to a maximum of 40 percent after 1970. If an individual chooses to do so, he may claim a deduction rather than a credit at any time. This graduated feature is incorporated into the program to enable the citizenry to gradually adjust to this new idea. It also will enable the State legislatures to decide exactly how they might best change their tax programs to pick up some of the slack which will be available from the reduced Federal tax burden which individuals must bear. For those who maintain that this program would seriously reduce Federal revenues, even to the detriment of national defense, I would point out that no corporate taxes are affected, and that even when the program is fully operational, only 40 percent of the Federal personal income tax will be creditable.

The most recent figures available from the Internal Revenue Service show that some $14 billion in State and local tax deductions were claimed in the 1964 tax year. Ten percent of this amounts to about $1.5 billion which might have been claimed in tax credits if section 13 had been in effect in 1964. From these figures, Mr. Speaker, it seems clear that the first year of operation under section 13 would have little or no additional impact on Federal receipts. With the war in Vietnam, it seems desirable to hold down the impact of such a provision in the first year of operation.

In summary, the main advantage of this section of my bill is that it will enable the States to alter their own tax programs however they decide to take advantage of the reduced impact of Federal taxation in future years.

While I am not going to discuss other tax credits in great detail, I would point out that they are completely consistent with the Republican philosophy of subsidiarity and of permitting as much individual choice as possible. At this time I would call the attention of my colleagues to the growing discussion of various tax credit and other "independent sector" programs.[3] These programs revolve around the concept that there are many areas of legislation in health, education, and welfare, which are being handled by Federal governmental programs simply because the field has been usurped and the resources available to the States have been taken up by the Federal Government.

Thus, with the tax credit device, it can be expected that while Federal tax obligations will decrease, local and State tax obligations will increase as these services are provided at the local level rather than the Federal level.

In this regard, I was happy to introduce legislation for the Republican Human Investment Act. This act, which was thoroughly outlined by the distinguished gentleman from Missouri [Mr. Curtis]—page H926, February 2, 1967[4]—provided for a tax credit to those employers who design programs to train prospective employees for jobs with a private company or retrain current employees for more demanding jobs with the company. I was pleased to join with some 130 of my

[3] For an illuminating discussion of this area see Richard C. Cornuelle, *If I Am Elected, I Will . . .*, New York City, 1966; and his *Reclaiming the American Dream*, New York City: Random House, 1965.

[4] All page numbers refer to the *Congressional Record* of the first sess. of the 90th Cong., unless otherwise indicated.

colleagues in this body, and 30 Republican Senators who introduced similar legislation under the able leadership of the distinguished Senator from Vermont, Senator Prouty.

Additional tax credit proposals have been introduced in such areas as air and water pollution by a number of my colleagues in both Houses of Congress.

I would also note that many of my colleagues on this side of the aisle have introduced tax credit legislation for educational expenses, for employers of the elderly, and for political contributions.

THE LEGISLATIVE DISCUSSION PROCESS

Mr. Speaker, as a firm believer in revenue sharing, I have introduced legislation into every Congress since 1958 to achieve a form of Federal-State fiscal balance, particularly with regard to financing education and other related activities.

I believe that when the appropriate committees of the Congress consider the revenue-sharing proposals which have been proposed, they will find that no one has, as yet devised the "best" plan for sharing Federal revenues with the States.

Clearly, a scheme that involves so many different factors must have many different elements which are worthy of consideration. This consideration will best be made during the legislative development process where witnesses from the various Federal, State, county, city, and other political subdivisions will testify.

In regard to committee hearings, I am encouraged that the distinguished gentleman from North Carolina [Mr. Fountain] has announced that the Intergovernmental Relations Subcommittee of the Committee on Government Operations is undertaking a broad study of the changing patterns, revenue sources, and requirements of governmental programs at the Federal, State, and local levels—(page H1196). These hearings, together with the hearings which are presently being held under the chairmanship of the distinguished gentleman from Maine, Senator Muskie, in the other body, should give an added emphasis to many of my remarks today. Certainly, much of the testimony in the Muskie hearings has repeatedly demonstrated the disadvantages of the grant-in-aid approach.

As many Members are aware, however, not all of the testimony before that subcommittee has been favorable to the revenue-sharing concept. The objections to it appear to have been on the grounds that the States will not pass the money along to the cities but rather spend it for rural projects which are considered of lower priority.

There are several answers to this objection. The first one is—and I wish to emphasize this point—any revenue-sharing plan which is acted upon by the Congress should have a provision written into it to require that a certain amount be passed on to the political subdivisions within the States. This is a very necessary requirement, in my opinion, and should become part of the general revenue-sharing bill that Congress finally enacts after hearing from expert witnesses on this question.

Another aspect of this question, of course, centers on the recent decisions of the Supreme Court which have required reapportionment of the State legislatures on the basis of population. Certainly, as Wal-

ter Heller maintains in his recent book, this should indicate that the State legislatures are going to be more responsive to the needs of their metropolitan areas in the future than they have been in the past.

Permit me to cite an example of why the legislative-development process is so necessary in evolving a truly good bill. Many of the proposals already introduced include provisions for the equalization of tax rebates to those States whose personal income tax is below the national median. Both the Goodell and Laird bills, for example, provide that 10 percent of the total funds allocated under the plan would be shared by those 17 States which have the lowest per capita income among the several States.

Some would argue against this method of equalization. Under these proposals, for example, only the lowest third of the States are helped. It may well be that an alternative method would do the job better. For example, one such alternative would provide that for every 1 percent by which a State's per capita income is below the U.S. average it would receive a 2-percent increase in its per capita allowance. This alternative, while more redistributive, would work more smoothly and gradually. Again, I emphasize, that these are aspects of the question which must be considered during the legislative discussion process.

Another objection that has been made to revenue sharing is that it tends to "freeze or even accentuate, existing differences" in tax collection rates.[5] This criticism has been specifically leveled at the Heller-Pechman proposal, and is inapplicable to the Goodell and Laird bills—which apportion the money partially on the basis of a "tax effort" ratio. A further comment which this same critic makes is:

> The most effective tool for aiding backward States in improving educational and social services is the familiar one of grants-in-aid by the Federal Government.

This assertion by Professor Ulmer, in spite of the demonstrated grave deficiencies in the grant-in-aid approach, is unjustified. The examples of inept handling of applications for grant-in-aid funds, of the conflicts which arise at the local level, and of other complications in this method are numerous as has been pointed out above. I would further mention in this regard that many State and local officials are willing to testify before the appropriate congressional committees concerning this inept handling. I ask that a number of letters and related material from these individuals be inserted in the Record at the conclusion of my remarks as appendix No. 6.

Another proposal has been made that a National Commission on Tax Sharing be established to report back to the Congress in 2 years. [Senator Nelson, page S128, S. 92.]

It is my belief that such a commission would be unnecessary. I would like to see the major committees of the Congress conduct hearings into the various proposals which have been submitted so that the best plan can be worked out. Frankly, I believe that after any such commission were established, their recommendations would be subjected to careful congressional scrutiny, whether it would recommend in favor of, or in opposition to, revenue sharing. Thus, such a commission would really accomplish nothing that could not be covered by the respective committees of the Congress.

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[5] M. Ulmer, Letters to the Editor, *Washington Post*, Jan. 29, 1967.

A further argument against the establishment of such a commission is that, when the President appointed a special task force to investigate this whole area, some two and a half years ago, the report was bottled up in the White House and has yet to be released to the Congress or the public.

Furthermore, the very nature of the legislative process, with its open hearings, with its witnesses from all levels of government, from business, labor, and the academic world, should provide an adequate forum for a full hearing for all viewpoints on the question of revenue sharing. It is my considered opinion that those who ask for a Federal commission to investigate this proposal are merely seeking to delay a measure that should be promptly considered by the Congress.

REVENUE SHARING FOR SPECIAL PURPOSES

Mr. Speaker, another aspect of this question which has been recently advanced on a number of fronts is the area of Federal revenue sharing for specific purposes, rather than for general purposes.

In this connection, I am pleased to note that the distinguished gentleman from Tennessee [Mr. Brock] introduced H.R. 308 on January 30, which would provide Federal revenue sharing for education. This particular bill, while limited to education, does not mean that the gentleman from Tennessee has withdrawn his support of the general principle of revenue sharing.[6] As he said when he introduced this bill on the floor of the House:

> I do want to make it clear that I have no desire to see this approach limited to education, and, that in no way does the introduction of this bill mean that I intend to withdraw my support from a broader and more general application of the tax-sharing principle (p. H756).

The Javits-Reid proposal is a limited revenue-sharing scheme. It would apply only to the general areas of health, welfare, and education.

Revenue-sharing proposals have also been introduced in other areas: On February 1, the gentleman from Florida [Mr. Gurney] introduced a plan for revenue sharing for law enforcement (p. H877).

The question will undoubtedly be asked by many: What is the advantage of a Federal revenue-sharing proposal which is limited to a particular area such as education or law enforcement? The answer was succinctly stated by the gentleman from Florida [Mr. Gurney] when he introduced his bill:

> The money could be used freely by the State and city law enforcement agencies, without the endless strings which are attached to the ordinary Federal grant. In this way, the States and cities could adapt these added resources to their own particular needs (p. H877).

This approach, then, is one which is certainly worthy of consideration, particularly if the Democratic majority seems unwilling to make an across-the-board Federal revenue-sharing plan realizable in this Congress.

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[6] As an early proponent of revenue sharing, Mr. Brock inserted a number of articles and related items in the *Congressional Record* on Aug. 25, 1965 (p. A4780).

These measures, while not as desirable, in my opinion, as an across-the-board revenue-sharing plan, are certainly steps in the right direction which deserve the wholehearted support of all of my colleagues on both sides of the aisle.

LEGISLATIVE STRATEGY

The Republican strategy on revenue sharing during this session of the 90th Congress will revolve around several aspects of the question. We will continue to press vigorously for early enactment of a general revenue-sharing measure to replace the existing grant-in-aid programs.

If the Democratic Members of this body fail to see the wisdom of our proposal, however, we will advocate bloc grants in place of specifically tied grant-in-aid funds.

The bloc grant approach, tied with an intensive attempt to enact a general revenue-sharing plan and to implement various tax credit proposals, represents a major Republican effort in this session of the Congress. On this subject, I include a Wall Street Journal article describing in general our legislative fallback strategy to enact revenue sharing piecemeal, if necessary, at the conclusion of my remarks as appendix No. 7.

Mr. Speaker, as an example of the strategy I would hope we will follow if no action is scheduled on a general revenue-sharing bill, I would cite title I of the Elementary and Secondary Education Act which will be up for renewal next year.

I would argue that substituting a bloc grant for title I earmarked for educational purposes but in no other way earmarked would make the program more effective, more efficient, and more likely to be utilized in ways that will attack top priority education problems within specific States.

Our States today are hamstrung in two vital ways; on the one hand, the Federal Government has largely usurped and dried up revenue-raising sources. This limits drastically the commitment a State or locality can make on its own to solve its most pressing problems. On the other hand, the burgeoning Federal bureaucracy more and more is attracting top talent in specialized fields from the States and localities. This reduces still further the State's ability to solve its own problems.

Revenue sharing, at least in part, would reverse both processes. All-important financial resources would be returned to the States for use on their most pressing problems which in Wisconsin may be totally different than the top priority problems in some other State.

At the same time, top talent which may have been attracted, say, to the Bureau of Elementary and Secondary Education in the Federal Office of Education, may be drawn back to a State Department of Public Instruction to help in developing that State's overall program in the field of education.

Mr. Speaker, such a reversal of the present trend of centering all significant problem solving in the Federal bureaucracy would lead to a more effective utilization of Federal dollars.

To me, revenue sharing—either in the form of bloc grants earmarked for general purposes, in the form of unconditional rebates or in some other compatible form like tax credits—is an exciting and promising

way to begin an effective attack on many of our major problems such as education in 20th century America.

Mr. Speaker, it continues to be my strong belief—and that of my party—that the key to solving the problems that face our society lies—as the framers of our Constitution knew so well—in decentralization of power, in decentralization of authority, in decentralization of "solution finding."

What we must do is look at our 50 States as 50 civic laboratories.

We know from scientific research that 50 different, separate efforts are better than one.

We may not come up with the best solution in all 50 laboratories, but we are sure of one thing when we decentralize: we will never come up with a single, worst solution applied to everyone.

That is the promise of revenue sharing, a program that has been a pet of mine for many years and that promises, in the not-too-distant future to go down in history as another idea whose time has come.

THE WISCONSIN PLAN

I first became aware of, and interested in, the great promise of the tax-sharing approach 20 years ago when, as a State senator in the Wisconsin Legislature, I saw tax sharing at work on the State level.

In Wisconsin, we have had a tax-sharing program for many years. Under the Wisconsin formula, 50 cents of the income tax dollar went to the community in which the taxes were raised; 10 cents went to the county in which that community is located; and the remaining 40 cents went to the State government when I was in the legislature.

As chairman of the legislative council in the late 1940's, my committee devised an equalization formula based on education factors that has worked well through the years in distributing the tax moneys in Wisconsin.

Most students of State government know that Wisconsin has a good record in good government and a good record in steady economic growth, in education, and in most of the measuring sticks that people use to judge the quality of life within the confines of a State.

I attribute a substantial percentage of the credit for the good situation we have in Wisconsin to the foresight of those who in our earlier history recognized the wisdom of revenue sharing as a viable and exciting way of running State government. Governor Knowles discusses the Wisconsin plan in his policy statement which is appendix No. 3 to my remarks.

As you know, Mr. Speaker, many of the categorical grant-in-aid programs administered by the Federal Government are set up on a matching basis. During my years in the State senate, I found, on occasion after occasion, that we were carrying on programs that were not of the highest priority in Wisconsin precisely because Federal funds were available for those lower priority programs on a matching basis but not always for the programs that should have received top priority in our State.

In 1953, I came to Congress. When the Department of Health, Education, and Welfare was created, I was appointed to the Appropria-

tions Committee in the House that finances all of that Department's programs.

By 1958, it was even more apparent than in my days as a State senator that the categorical grant-in-aid approach was at the very most a second-best method of attacking the problems in our society at the Federal level.

It was at that point that I introduced the first tax-sharing legislation that would apply the principle of the Wisconsin plan to our country as a whole.

I remain convinced that this is one of the most promising ways out of our present dilemma.

THE BETTER WAY

Mr. Speaker, revenue sharing is a better way for Americans to do things than the way of the "great planned society." It offers a meaningful and effective "creative federalism":

A creative federalism that recognizes the role the Federal Government must play.

A creative federalism that also recognizes that the great society of America was created through vast diversity and not narrow conformity.

A creative federalism that supplements rather than supplants the creativity of State and local people and their governments.

A creative federalism, in short, that fosters decentralization without emasculating the legitimate role of a central government in modern society.

No man in public life dismisses the agonizing problems we face as we look to the future.

But there still remains a basic disagreement between men of good will on the question of how best to attack our problems.

Proponents of the categorical, specialized Federal grant have had their day in court.

They have lost their case after a lengthy and fair hearing.

It is time now to try a new, more efficient and more promising way of moving America forward in this second half of the 20th century.

The better way is the revenue-sharing way.

REVENUE SHARING*

BY Senator JACOB K. JAVITS (R., N.Y.)

Mr. JAVITS. Mr. President, my bill would accomplish a number of objectives in an effort to bring about better equalization between the tax resources upon which State and local governments can draw and those which are preempted by the Federal Government. This is a problem which every State—including my own State of New York, which has the second largest tax revenues in the country—must solve.

The Javits plan would provide as follows:

First. Establishment of a trust fund in which 1 percent of aggregate taxable income would be deposited from the Treasury, beginning July 1, 1967. Under present conditions, this would amount to $2.5 billion a year and would grow as the tax base grows. Transfer from the Treasury to the tax-sharing trust fund would take place at least once every 3 months.

Second. Payments from the trust fund to the States under the following formula: (a) 80 percent would be distributed on the basis of population. This amount would be increased or decreased depending on the State's own tax effort, which would be measured by the ratio of the total revenues derived by the State over total personal income of individual State residents, as compared with the national average; (b) 20 percent of the fund would be paid each fiscal year to the 13 States with the lowest per capita income. This would be distributed according to population of the States involved.

Third. No State could receive a total payment for a fiscal year in excess of 12 percent of the trust fund in that year.

Fourth. A State may use its allotment of funds for programs in the fields of "health, education, and welfare," but not to include (a) debt service of the States, (b) general administrative expenses for the executive, legislative, or judicial branches of State and local government, (c) highway programs, (d) State payments in lieu of real property taxes, (e) disaster relief.

Fifth. To benefit from the plan, a State must file reports with the Secretary of the Treasury, the Comptroller General, and the appropriate committees of Congress, including a statement of intent as to how and for what purposes it shall spend the money. States must also comply with all applicable laws including title VI of the Civil Rights Act of 1964. The Secretary of the Treasury must provide a detailed audit report to the Congress annually on the operation of the trust fund during the preceding fiscal year and on its expected operation during the current fiscal year.

Sixth. Failure to comply with prescribed conditions would require cancellation of future payments and permit reallocation of the re-

*Speech by Senator Javits of New York, reprinted from *Congressional Record*, Oct. 11, 1965.

mainder of a State's allocation to other States in proportion to the original allotment.

Seventh. The State must distribute to its local governments an equitable portion of its allotment. The amount distributed to local governments must be no less than the average of the State's distribution of its own revenues to local governments over the previous 5 years.

Eighth. Appropriations Committees of both Houses and the Finance Committee of the Senate and Ways and Means Committee of the House, responsible for appropriations and tax legislation, must, at least once during each Congress, conduct a complete study of the operation of the trust fund and provide such legislative recommendations as appropriate.

The measure I introduce today is designed to provide a workable formula to channel Federal revenues to the States with a minimum of strings attached in order to restore fiscal balance to the Federal-State partnership and to strengthen the capacity of local governments to serve their citizens effectively.

The general outlines of a plan to distribute Federal tax revenues to the States was first suggested in June 1964 by Dr. Walter Heller, then Chairman of the President's Council of Economic Advisers. It has since been endorsed by a task force of economists headed by a task force of economists headed by Joseph W. Pechman, of the Brookings Institution. It was supported by the Republican Governors Association last July as well as by numerous conferences of local officials. But no concrete plan has yet been formulated as to the precise allocation of Federal funds for a wide range of State activities. Despite its complexity, I believe Congress should have before it now a carefully drawn proposal embodying this plan so that it may be fully considered by congressional committees during the period between sessions and may be the subject for hearings early in the second session.

State and local governments face a severe crisis. While the future with its demands for new services is rushing in on them, they remain victims of a financial revenue base which is years out of date. In the past 18 years, total State and local government expenditures have multiplied six times over. State and local outlays for education alone increased from $3 billion at the end of World War II to $22 billion last year. In the past 10 years, these expenditures, now totaling about $87 billion per year have risen at 8 percent per year, twice as fast as the gross national product. In contrast to this, the Federal Government made cash expenditures during fiscal year 1965 excluding costs of national defense, of $66 billion.

The sad fact is that the present resources of State and local government are not sufficient to meet the expanding needs caused by exploding population, rapid urbanization, and advanced technology; nor is there any indication that this situation will correct itself. Indeed, almost every imaginable tax resource has already been subjected to increasing and sometimes undesirable pressures. State taxes alone have gone from $4.9 billion in 1946 to $24.2 billion in 1964, an average increase of over a billion dollars a year. In 1965, property taxes increased 7.3 percent over the previous year; sales taxes went up 8.7 percent, corporate and individual income taxes rose 7.5 and 6.3 percent respectively—all in 1 year.

In 1964, State tax increases siphoned off one-third of the $6.5 billion Federal tax cut. Despite warnings from economists, a bewildering

variety of consumption, payroll, and service taxes have appeared at the local level from Detroit to Oakland, Fairbanks to Mobile, Los Angeles to Baltimore. Over 40 cities have recently imposed motel and hotel taxes in an effort to shift some of their tax burdens to nonresidents. In a frantic search for additional revenues, New Hampshire has instituted a State-sponsored sweepstakes on horseracing.

The end is not in sight. Twenty-six Governors have asked for tax increases this past spring and many of those who are relying on larger yields from present taxes have warned their legislatures that increased taxes are a future necessity. Yet there is evidence that traditional taxes have already reached the limits of desirable expansion.

Dramatic proof of the growing disparity between government responsibilities and government resources is found in the increase in State and local debt. From a $15.9 billion level in 1946, public indebtedness at the State and local level almost doubled by 1952. Since that year, State and local debt has tripled, an average increase of more than $4½ billion per year.

State governments, which can tap a wider variety of revenue sources than local authorities can, have been active in using these sources. Between 1946 and 1963, no less than 14 States instituted a tax on cigarettes, while sales taxes were added as a source of funds by 13 States. At the same time, four States added an individual income tax. Of course, virtually all States have also increased rates on previously tapped tax sources.

The financing of local government expenditures has been a problem of at least similar difficulty. These governments rely almost exclusively upon property tax revenues. While the postwar increase in property valuations has swelled the property tax base, there has still been a steady need to raise the property tax rates themselves.

Interstate competition to attract new industry—and similar competition among localities—has undoubtedly hampered efforts to add to current revenues, particularly in the case of corporate taxes. States and localities generally offer some form of inducement to attract new corporations to their areas, with the long-range objective of creating new job opportunities and increasing the overall tax base, and this competition tends to restrain local governments from increasing tax rates.

In the face of heavy demands placed upon State and local governments, the increase in their taxes and borrowing has been insufficient to prevent them from becoming gradually more dependent upon financial assistance from the Federal Government. The bulk of Federal assistance in the form of grants-in-aid programs has grown from a total of $884 million in 1946 to approximately $11 billion in 1965. In 1964 the Federal expenditure of $9.8 billion represented approximately 16.7 percent of total taxes and other general revenues raised by State and local governments, compared with only 7.3 percent in 1946. Grants to help support public welfare programs and to help build public roads and highways have shown the sharpest increase over the postwar years, and together they totaled some $7.5 billion in 1964.

Despite their achievements to date, State and local governments will continue to face a wide variety of additional public needs, and they do not want to curtail their responsibilities. They have doubled their employment over the past 13 years and increased their budgets many

times. Obviously, problems of water and air pollution, overcrowded schools, and substandard recreation and housing facilities, as well as inadequate health care exist. In our vast and diversified country, these services can often be most effectively provided only through programs run at the State and local level. Thus, the immediate problem is to develop intergovernmental relationships that will enable State and local governments to carry out their vital role. Innovation and experimentation will be needed in future Federal-State cooperation and in planning and budgeting public programs if we want to get maximum benefit out of every dollar spent.

Under the plan I introduce today, New York whose 1963–64 State and local revenues amount to $7,445 million—the second largest in the Nation—would receive $202 million; Alaska, with State and local revenues during this period amounting to $89 million—the smallest in the Nation—would receive $2.6 million. Similarly, California would receive $213 million and Arkansas, $47 million. Through this plan, for example, New York would receive a 31-percent increase in Federal aid; California, 17 percent; Ohio, 20 percent; Alabama, 39 percent; Colorado, 16 percent, and Kentucky, 37 percent.

It may be argued by some that State and local governments will not use these Federal funds wisely or that they will use them to reduce their own taxes and expenditures for necessary programs. Experience of the past, however, indicates that such fears are groundless. A large proportion of total State and local outlays over the past years have been used for educational, health, and welfare purposes—an indication that local governments are cognizant of the needs of their people in these areas and are attempting to meet them.

Grants made to State and local governments under a plan such as this will enable these bodies to operate more independently. Local officials will be free of Federal domination, and the spread of a growing Federal bureaucracy may be halted. State and local governments will be in a stronger financial position, and a better fiscal balance will be achieved between Federal, State, and local governments.

Now, let me direct one word to those who may feel that the sort of tax-sharing plan I propose would mean further incursion on State prerogatives. Of course, there is always a possibility that this can happen, but the choice we face is not between State dollars and Federal dollars, but between Federal dollars bound by strings and conditions and funds which are relatively unconditional and can help buttress the capability of State and local governments to carry their responsibilities and not to abdicate authority to the Federal Government due to financial inability to discharge it.

For, we have to look to the days and years ahead when the demand for more and better local governmental services will increase.

Critics on the one side of the political spectrum are suspicious of the States and seemingly convinced of Federal "Infallibility"; critics on the other side are suspicious of Washington. But mutual suspicions should not produce a deadlock, for this country cannot be governed well unless Government is imaginative and active and responsible and works at all levels in a Federal-State system.

I feel that the proposal embodied in the bill I introduced today can help prepare our governmental system to meet needs of the coming decades, and can help us to put cooperative federalism into practice for the benefit of all our people.

THE CASE FOR TAX SHARING—A POLITICAL VIEW

BY RICHARD P. NATHAN*

For purposes of this paper, the term "tax sharing" refers to various proposals to have the Federal Government provide a new form of general and less conditional financial aid to State and local governments. The basic premise involved is that these general aid allocations are a means for the Federal Government to share its elastic tax revenues (viz, from individual income taxes) with States and localities.

It should be stressed here that under any tax-sharing plan Congress is sure to impose certain broad conditions as to the use and distribution of tax-sharing funds, e.g., state planning, a Federal audit, civil rights, and a State-local pass through requirement. The tax-sharing idea does not simply involve "stump money"—putting money on the stump and running the other way. Rather, it involves the adoption of a new, broader, and less conditional Federal-aid instrument.

Proposals for a new Federal-aid instrument of this kind have been made over the years, particularly in the academic community. Diligent students in this area are also obliged to point out that in 1837 (under Andrew Jackson) a short-lived Federal surplus distribution program was adopted which in many respects resembled the types of tax sharing proposals now current. Yet, the rise of tax sharing to its present level of serious consideration is of relatively recent date. In the spring of 1964, Walter Heller, then Chairman of the President's Council of Economic Advisers, proposed a general aid or tax-sharing plan to President Johnson. Heller apparently did this with the thought in mind that—following the 1964 tax cut—the next declaration of a "fiscal dividend" should be focused on the *public* sector of the economy. This proposal was developed in further detail during the summer and early fall of 1964 by a Presidential Task Force and eventually became known as the Heller-Pechman plan.[1]

TAX SHARING INCREASINGLY SEEN IN POLITICAL TERMS

An important distinction must be made at the outset as regards the evolution of the tax-sharing idea since 1964. Tax sharing came to national attention in 1964 in the context of national fiscal policy planning. But, as it achieved stature, it has increasingly been justified and defended in *political* terms. That is to say, concern about the "delivery" problems of the Great Society (i.e., the delivery of public services to their intended recipients) and about the vitality and proper role of

*The Brookings Institution, May 18, 1967. The views and conclusions presented in this paper are those of the author and do not purport to represent the views of other staff members, officers, or trustees of The Brookings Institution.

[1] Joseph Pechman, Director of Economic Studies of The Bookings Institution, headed the Presidential Task Force which studied the Heller proposal and recommended its adoption to the President.

sub-Federal levels of government have come more and more into play as arguments of proponents of various forms of tax sharing.

Concern about administrative problems under existing Federal-aid programs is currently widespread. To give the reader a very small capsule view of the types of concerns that have been expressed, it is useful here to quote several prominent commentators on the present state of the Federal grant-in-aid system.

Referring to the 1962 existing "major" grant-in-aid programs Budget Director Schultze said at recent Senate hearings:

> (The) Complexity and fragmentation of Federal grant program is and of itself creates major problems of administration and information flow, for both the Federal and local governments, and inhibits the development of a unified approach to the solution of community problems.[2]

Senator Robert Kennedy observed cryptically in questioning a witness at the same hearing:

> As a result of this duplication, anyone who wants the benefit of a particular program must struggle in this mass of bureaucracy with HUD, HEW, and OEO. . . . I think this is terribly frustrating for all of our people across this country . . . if we can get to the moon, it just seems to me we do not have to sit here and be frustrated year after year about how to coordinate the Federal Government.[3]

The National Governors' Conference, in a December 1966 Resolution, described the current Federal aid situation in the following terms.

> Existing categorical Federal-aid programs in many instances impede State and local governments from meeting priority public needs in a manner effectively suited to the varying problems and needs of individual State and local governments.[4]

On the Republican side, this same theme has been strongly emphasized in the 90th Congress. According to Republican Congressman, Melvin R. Laird:

> Every day we read that the proliferation of categorical Federal grant-in-aid programs is causing a real crisis in the management and control of our government. Indeed, it can be argued that many of these overly specialized grant programs compound the problems they are designed to resolve.[5]

Looking at this situation from the State viewpoint, Gov. Nelson Rockefeller at the Muskie hearings on "Creative Federalism" referred to the "growing awareness of the strains placed on the federal system by many existing Federal programs and policies which warp intergovernmental relationships." [6]

Finally, we consider briefly the community viewpoint. In one area of Federal aids—manpower programs—a recent study summarized the the current situation as follows and stressed the importance of "the

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[2] *Creative Federalism,* Hearing before the Senate Subcommittee on Intergovernmental Relations, 89th Cong., second sess. (1966), p. 390. (The subcommittee chairman is Senator Muskie of Maine.)

[3] *Ibid.,* pp. 409, 415.

[4] National Governors' Conference, Interim Meeting, White Sulphur Springs, W. Va., Dec. 16–17, 1966, Special Study Committee on Revenue Sharing of State and Local Governments, Resolution No. 1.

[5] Statement, Apr. 21, 1967.

[6] *Creative Federalism,* Hearing, Feb. 1, 1967.

art of grantsmanship" for communities interested in securing Federal aid:

> A community, unified in its approach to manpower problems, knowledgeable concerning the various programs, their funding arrangements and eligibility rules, skilled in the art of grantsmanship and competently represented in Washington, has dangled before it an impressive variety of Federal supports, some of which are distributed by fixed formula and others requiring community initiative. The community which lacks sophistication about the maze of programs and regulations may never discover the handles that turn on the spigots of Federal aid.[7]

Where Are We Today?

In the eyes of many of the current proponents of tax sharing, this increase in the number, size, and complexity of Federal categorical aids has reached a point where its cumulative effect has relegated States and localities to an increasingly weaker position vis-a-vis the Federal Government. *Tax sharing, in effect, is an instrument for changing the emphasis and placing more reliance on States and localities as a means of restoring balance within our total governmental system.*

To be sure, the fact that almost all current tax-sharing plans are regarded as supplementary to existing Federal aids and do not entail their elimination suggests that the adoption of a Federal tax-sharing plan should not be regarded a radical new policy direction. Nevertheless, the tax-sharing idea is linked with, and would encourage, a basic process of political change. Were it not for this political significance, it is highly doubtful that the tax-sharing idea would have gotten as far as it has.

At its roots, the tax-sharing issue involves people. The way in which the individual, as a citizen, relates himself to the political process is an essential element of the workings of a free society. If a greater number of important decisions are made at the State and local levels as a consequence of tax sharing, many would contend that this is good in that it strengthens the ties of the citizens to the political process. But, the issue is not simply a matter of placing more stress on government "closer to home" (although this, in part, is what is involved). It is also a matter of encouraging governmental *flexibility* and *innovation* in response to localized conditions and needs.

These three basic elements of American federalism—participation, flexibility, and innovation—are at issue in many current discussions of the future of American intergovernmental fiscal relations. Secretary of Health, Education, and Welfare John Gardner recognized and stressed these fundamental political ideas at the Muskie subcommittee hearings:

> We must revitalize State and local leadership so that it can play its role vis-a-vis an increasingly powerful Federal Govern-

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[7] Sar A. Levitan and Garth L. Mangum, "Making Sense of Federal Manpower Policy," (A Joint Publication of the Institute of Labor and Industrial Relations, University of Michigan-Wayne State University, and the National Manpower Policy Task Force, March 1967), p. 14. A good illustration of this heightened sophistication on the part of some grant-receiving local governments is the employment of professional "grantsmen" in Washington with rates, according to the *Wall Street Journal* (Nov. 22, 1966), of $100 and even $125 per day.

> ment. . . . It is the only way to preserve our position of dispersed power and initiative.[8]

The same theme was expressed succinctly in a column by Walter Lippmann.

> The fact of the matter is that the country is too big to be managed and administered from Washington.[9]

THREE THEORIES OF FEDERALISM

This brings us to the point where it is useful to consider the basic theoretical underpinnings of American federalism. Following are brief descriptions of three major and relatively current conceptions of federalism as a means of organizing political power.

Arthur Macmahon (Columbia University Professor of Government), in a book which he edited, *Federalism; Mature and Emergent* (1955), defined a federal system as one which "distributes power between common and constituent governments under arrangements that require Constitutional amendment to change." [10] All constituent governments must have "substantial" powers of their own, that is to say a system under which only "trivial" powers were assigned to one level would not be considered federal according to Macmahon's definition.[11]

Another and quite different view of federalism rejects this traditional and static definition in terms of the allocation of "substantial" powers. It stresses the *evolutionary* character of federalism. Harvard Professor of Government, Carl J. Friedrich, defines federalism principally in terms of "process." [12] Federal systems are seen as moving through time from loose groupings of separate states to increasingly more integrated and unified nations. In many respects, the American system bears out this point, having become increasingly more integrated politically over the years.

Still a third view of federalism defines it in terms which Professor Friedrich might consider a highly advanced stage of this evolutionary process. The late Prof. Morton Grodzins of the University of Chicago likened American federalism to a "marble cake, characterized by an inseparable mingling of different colored ingredients, the colors appearing in vertical and diagonal strands and unexpected swirls. As colors are mixed in the marble cake, so functions are mixed in the American federal system." [13] Grodzins' essential point was that federalism is *pragmatic*. No powers reside intrinsically here or there. Federal systems consist of relationships among governmental bodies designed to get the job done. To Grodzins—though certainly not to Macmahon—"the Federal structure is a means, not an end." [14]

These three definitions are highly relevant as we look at the structure of American federalism in 1967. There is today a quite sharp division as to what our Federal system is and should be. Centralists—those with a decided perference for Federal initiatives and action—would be in the Grodzins camp. Federalists—those who see purpose in

[8] *Creative Federalism*, hearing (1966), p. 268.
[9] *Washington Post*, Jan. 8, 1967.
[10] Arthur W. Macmahon, (Ed.), *Federalism Mature and Emergent* (Garden City, Doubleday & Company, Inc., 1955), p. 4.
[11] *Ibid.*
[12] Carl Joachim Friedrich, *Man and His Government* (McGraw-Hill, 1963), p. 594.
[13] President's Commission on National Goals, *Goals for Americans* (New York: The American Assembly, 1960), p. 265.
[14] *Ibid.*

conserving a viable and balanced federalism—would find Macmahon's view more to their liking. Both sides would probably agree with Friedrich's more or less middle position that federal systems evolve over time, but would differ as to how much evolution is desirable.

In effect, the critical question embodied in the tax-sharing idea is to decide on the amount of *political change* we want in reference to a continuum that has on one side the more traditional Macmahon version of federalism and the other side the most centralist Grodzins view.

Now to take the next step. This question as to the kind of a Federal system we want in 1967 must be answered in relation to its broad historical setting.

Money—The Key to Changing Federal Systems

Certainly, Professor Friedrich is right that the American Federal system has undergone a long and gradual process of change. While this process has importantly involved legal jurisdictional lines between the Federal Government and the States, *money* appears to have been the key. Another political philosopher, Karl Loewenstein, stresses the income tax as an essential element in the aggrandizement of central authority vis-a-vis the States. A state with a federal or central government income tax, according to Loewenstein, is no longer a genuinely federal state.[15]

The central governments of all five of the major countries which are presently regarded as having federal governments levy income taxes (United States, Australia, Canada, Switzerland, and West Germany). In the first four, federal income taxation was inaugurated in response to World War I military needs. When the war ended, the central governments had full coffers and the regional governments (in our case States) had large war-neglected public service needs. The logical response was grants-in-aid. And with the greatly expanded postwar use of these instruments, the evolution of federalism was sharply stepped up.

The increase in grants-in-aid in the United States can be traced to (1) the adoption of the war-related Federal income tax in 1913 and (2) the Federal Government's response to the Great Depression.

Under the New Deal, categorical Federal aids were enacted to meet a wide range of specific federally defined domestic needs.[16] This trend toward greater reliance on categorical-type intergovernmental fiscal instruments has continued (although the growth pattern has been rather sporadic) over the 30 years since the New Deal was born. The history of the development of categorical grant-in-aid programs under and subsequent to the New Deal is well known and need not be repeated here.[17] The important point for this paper is the impact of

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[15] Karl Loewenstein. *Political Power and the Governmental Process* (The University of Chicago, 1957), pp. 293–204.

[16] This is not to imply that there were no Federal grants-in-aid prior to the New Deal, rather that it represented a sharp increase in their use and size. Grants date back to the pre-Constitution period when Federal land grants were made to the States broadly for education and internal improvements. Categorical grants began to be used in the years after World War I. The U.S. Supreme Court in *Shepard* v. *Towner* (1923) first endorsed the categorical grant-in-aid approach. The Court said the powers of States were "not invaded" as the grant "simply extends an option which the State is free to accept or reject."

[17] See the author's article, "The Policy Setting. Analysis of Major Post-Vietnam Federal Aid Policy Alternatives," in this *Compendium*, for historical material on the development of the various major federal aid programs.

this growth in the size and number of Federal aids on the political structure of American federalism. Its effect upon States and localities has in many cases been to reduce the scope of State-local decision-making, which, in turn, has been one reason for the relative decline in the vitality and creativity of many financially hard pressed State and local governments in the post World War II period. Federal aids and the required matching funds tend to structure State and local budgets, sop up new State-local revenues for matching, and force States and localities on the whole to devote more of their own resources to basic and continuing governmental functions, while the Federal Government takes all the bows for new initiatives.

Admittedly, this is too simple a picture. Many of the wealthier States and localities have had a consistent tradition of vigorous and modern government despite the rise in the number and specificity of Federal aid programs. Others have lagged and have needed and deserved the prod of Federal aid. Taking an overall view, however, the fact remains that there has been increasing central fiscal dominance in American domestic affairs traceable to the superior *income* tax resources of the Federal Government—a tax adopted initially as a response to war, now used in large part to finance categorical, "strings attached" Federal financial aids for States and localities.

In a very real sense, the rising popularity of the tax-sharing idea is a part of this history of American intergovernmental fiscal relations. Implicit in the tax-sharing idea, as has already been pointed out, is the conviction that we have come to a point in our history when it is necessary to adopt new intergovernmental fiscal policies which reflect a change in emphasis, giving more discretion and responsibility to State and local governments and moving away from an overreliance on central direction and controls.

Moving Into the Real World

The usual response to this political-historical line of argument is that, while all of this is well and good for those with a theoretical bent, in the real world the case for getting the job done far outweighs the case for tax sharing in these philosophical terms. Tax sharing should not be adopted because State and local governmental machinery is not up to the standards necessary to meet even existing demands upon it, much less the challenges of the future.

Like any generalization, illustrations can be cited on both sides of this contention. Proponents of tax sharing cite progressive new leadership at the State-local level and successes achieved in such areas as State constitutional reform and governmental reorganization. Opponents stress legislative deficiencies and the bad examples of exceptionally weak State and local governments. This is to be expected. Individual experiences and views are bound to differ as to the "quality" of so large and heterogeneous a universe as American State and local government. But, even conceding that some States and localities have a great deal more to do in the way of governmental modernization and reform, three questions arise which suggest that a simple canvassing of deficiencies in governmental machinery in States and localities where it is known to be weak is not a good basis on which to reject a new and broader Federal aid instrument.

First of all, even if one concedes that some States and localities have lagged in modernizing their governmental machinery, is this sufficient reason to penalize the rest by continuing to rely on specific Federal aid instruments? This can be considered the interarea distributional side of the governmental machinery issue.

A second question relates to the recent developments mentioned above. If, as has been suggested by the Muskie subcommittee hearings, the Federal Government itself is having serious problems in administering existing Federal aids, could it not be that the efficiency believed to be gained by having the Federal Government structure Federal-aid spending patterns is less than has heretofore been assumed? Stating this question more sharply, can we be so sure that "delivery" via Washington is that much better (in terms of efficiency and the targeting of objectives) than would be the case if a tax-sharing plan were adopted with general congressional conditions as to how the funds so allocated are to be used?

Digging even deeper, there is a basic philosophical question involved. Even assuming that the categorical Federal-aid approach is more efficient or effective (whatever the criteria), isn't there a danger that too much is lost in the process? Could it be that the strength and responsiveness of State and local government are "worth" a certain minimal cost because of the importance of these governmental entities to our pluralistic, citizen-oriented political system?

No serious proponent would argue that tax sharing should be adopted regardless of the social costs, or that it is the only new policy direction that should be adopted once the war in Vietnam is over or defense expenditures for the war are scaled down significantly. What is contended is that—in addition to other priority post-Vietnam domestic policy goals—there is a definite need to consider a major new policy instrument for loosening up the existing Federal aid network and placing more reliance on the role of State and local governments in our total political system.

When the war in Vietnam ends, substantial resources will be available for other than defense purposes; for example, tax reduction, family allowances, more aid for the core city, antimissile missiles, increased foreign aid. Tax sharing is but one of several possible post-Vietnam domestic policy instruments, with its particular purposes being (1) to loosen up the Nation's total intergovernmental fiscal-administrative system, (2) to place greater emphasis on the role of sub-Federal governmental jurisdictions, and (3) last but not least, to strengthen the Nation's total capacity to meet domestic economic needs, which have been deferred during the current war effort.

Conclusion

So that the reader will be clear on what are considered the major policy conclusions of this paper, it is useful here to reiterate two key ideas presented above.

First, the tax-sharing idea must be seen in *political*, as well as economic terms. That is, it must be seen in terms of its longrun meaning as regards the participation of citizens in the governmental processes of a large and complex free society such as our own. It is contended

in this paper that federalism is a real, and not just an abstract philosophical issue. The way in which the individual, as a citizen, relates to his community is an essential element of the workings of a free society. It is all the more essential today with the steady growth of the urban communities in which most Americans live and the increasing complexity of public policy issues.

Second, the tax-sharing idea must also be viewed in the *broader fiscal policy context* in which it is but one of several competing alternative uses for a potential future "fiscal dividend." The tax-sharing approach, if adopted, is bound to be combined wih other public sector fiscal policy alternatives. The essential point to be made here is that tax sharing should not be considered in a vacuum. The real issue of tax sharing is: should it be a part of the *mix* of major fiscal policy alternatives adopted when economic and Vietnam-related conditions permit?

Finally, it should be noted that this paper is limited to a political view of the case for revenue sharing. The economic case for revenue sharing is presented in other places.[18] Briefly stated, the economic case for tax sharing encompasses the need to meet growing State-local public expenditure demands in neglected and inadequately financed areas (e.g., mental health, recreation, urban development, higher teachers' salaries and other educational needs), problems involved in relying further on State-local taxes sources which are relatively less flexible and progressive than those of the Federal Government, and the need to direct greater attention to disparities in fiscal capacity among the States.

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[18] See, for example, Walter W. Heller, *New Dimensions of Political Economy*, ch. III, "Strengthening the Fiscal Base of Our Federalism," (Cambridge: Harvard University Press, 1966) and Joseph A. Pechman, "Money for the States," *The New Republic*, Apr. 8, 1967.

THE ELEMENTARY ERRORS OF TAX-SHARING

BY MELVILLE J. ULMER *

Proposals for tax sharing, by which a portion of Federal income tax receipts is turned over to the States, are commonly based on five fundamental propositions. Since each is essential to the general argument, it is important that they be carefully examined for possible defects in fact, logic, or principle. This is the task essayed in this paper.

The five basic propositions, upon which tax-sharing proposals rest, are as follows:

1. The States have exhausted the sources of revenue available to them, particularly since the Federal Government has preempted the major revenue producer, the income tax.
2. Tax sharing is an equitable method of raising money to meet State and local needs.
3. Tax sharing is an efficient method for meeting public expenditure requirements at the State and local level.
4. In the years ahead the need for funds of State and local governments will grow more rapidly than revenue, so that additional sources of revenue are necessary.
5. Democratic principles as well as government efficiency will be served by retarding the growth of the Federal Government while expanding the activities of the States, as tax sharing would do.

I. THE ALLEGED EXHAUSTION OF STATE AND LOCAL REVENUE SOURCES

The financial situations of the State and local governments vary so enormously that very few generalizations about them are possible. One generalization that surely cannot be admitted is that the potential sources of revenue available to these governmental bodies have already been exhausted. Gross State and local revenues as a percent of personal income range from lows of 4 to 8 percent in States such as Connecticut, Illinois, Missouri, New Jersey, Ohio, and Virginia to highs of 16 or 17 percent in some others. The implication of even this crude measure is that many States could at present double or triple their taxes without asking more of their residents than other States are presently asking, and getting, from theirs.

Even more to the point is the great variation among States in the use of the income tax, which many authorities believe to be the most equitable of all possible levies. Despite the claim by some that the Federal Government has preempted this major revenue producer, six States currently manage to derive a considerable proportion of their total receipts from this source. In these States, the marginal personal

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income tax rates range to as high as 10 percent or more at the income level (after personal exemptions) of $15,000 or over.[1] But the other 44 States fall far below this standard. Seventeen States levy no general tax at all on personal incomes.[2] In most of the others the maximum tax rate imposed at any income level is 5 percent or less, and in some the maximum marginal rate is as little as 2 or 3 percent. The conclusion seems inescapable that in the majority of States important sources of revenue remain unexploited. This conclusion is reinforced by observation of the great variation in the use of the other principal State and local levies. Corporation incomes are not taxed at all in 13 States, and in the others the rates range from small fractions of 1 percent up to 6 or 7 percent. Eight States have no general sales tax, and in the others the rates range from 2 to slightly more than 4 percent. Property is taxed by virtually all local governments, but the average effective rates are fully five times as high in some States as they are in others.[3]

Of course, there is no intention to imply here that the tax systems of the 50 States ought to be precisely the same. But the tremendous variation just described can hardly be explained in terms of warranted reactions to structural differences in industrial organization or in the distribution of income. The conclusion seems unavoidable that the States differ greatly in willingness to meet their respective social obligations. More significant for present purposes, the data given in the preceding paragraphs make clear beyond a doubt that the great majority of States could increase their revenues very substantially, from their own resources, by simply requiring as much from their citizens as a few conscientious states are now asking of theirs. Even a modest move in this direction by the less conscientious States would result in increasing total State and local revenues in the years ahead by 10 percent above the levels they otherwise would reach.[4] Really vigorous efforts could raise revenues by 50 percent.[5]

II. The Alleged Equity of Tax-Sharing

It follows from the analysis of the previous section that families in the same income bracket are taxed very differently in the different States. Tax sharing would actually compound this inequity by placing a greater relative burden on those who are already taxed more heavily

[1] These States are Hawaii, Minnesota, New York, North Dakota, Oregon, and Wisconsin.

[2] These States are Connecticut, Florida, Illinois, Maine, Michigan, Nebraska, Nevada, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Washington, and Wyoming. Three of these States have partial taxes on personal incomes: New Hampshire and Tennessee tax income from dividends and certain interest receipts, and New Jersey taxes the incomes of New York residents that are derived from New Jersey sources.

[3] The Advisory Commission on Intergovernmental Relations, *Tax Overlapping in the United States: 1964*, Government Printing Office, 1964, table 40, p. 89. The other data in this section are from this publication, its December 1966 supplement, and from *Governmental Finances in 1964–65*, Bureau of the Census.

[4] The modest adjustments include (1) adoption of the personal income tax, with the 1965 *average* rate and coverage, by all states with no personal income tax or with a relatively low rate or narrow coverage; (2) adoption of a broad-based sales tax, with the 1965 average rate and coverage, by all states with no sales tax or with a relatively low rate or narrow coverage; (3) general adoption of professional, periodic property tax assessments and the abolition of special property tax exemptions. See *A Fiscal Program for a Balanced Federalism*, Committee for Economic Development, June, 1967, p. 37.

[5] Vigorous efforts imply lifting state and local revenues in all states, as a percent of personal income up to the levels that prevailed on the average in the five highest states in 1964–65.

by the State and local governments. We shall illustrate this proposition with the simple example given in table 1.

TABLE 1.—*Impact of tax sharing in high and low tax States—Hypothetical example*

	Taxable family income	State tax	Income after State tax	New State tax under tax sharing	New State tax as percent, at margin
High tax State	$10,000	$5,000	$5,000	$1,000	20
Low tax State	10,000	0	10,000	1,000	10

In this example, we shall consider the impact on two families with the same income (assumed to be $10,000) before taxes, but living in different States. To keep the arithmetic simple, it is assumed that one family, in the high tax State, pays $5,000 in State and local taxes; for the other family, it is assumed that State and local taxes are zero.[6]

Now the tax-sharing proposal may be looked upon as a two-stage adjustment. Initially it calls for a reduction in the Federal income tax by some flat proportionate amount. Secondly, it calls, in effect, for imposition of a State tax by exactly the same absolute amount.[7] Let us suppose that for a family with a $10,000 income, the amount of this tax-sharing comes to $1,000, as shown in the fourth column of the table. For the family in the high tax State, the new State tax will represent a 20-percent levy on its income, after payment of existing State taxes. For the family in the low tax State the new tax will represent only a 10-percent levy. Notice that no assumption has been made about the average income levels of the two States in the example. Both could be rich, both poor, or either one could be rich or poor. The inequity described would remain so long as existing taxes differ widely among the States, as they so definitely do. For example, the principle would apply as well if we were to imagine that the high tax State was New York or California and that the low tax State was Illinois or New Jersey. All four of these States are in the same general range of per capita income, yet the levels at which they tax families in the same income bracket are very different.

The inequity of tax sharing may be described more succinctly by use of utility analysis. Assume that families in the same income bracket have similar utility functions with respect to money income, regardless of where they are located, and that the law of diminishing marginal utility is valid. Then the cost of a Federal tax cut foregone, in terms of utility, will be greater for the family in the high tax State than for the one in the low tax State. Suppose, further, that the potential benefits received from State and local expenditures under tax sharing were equal in the two States. Then for equal public benefits at the State and local level, the family in the high tax State would be sacrificing more

[6] Although for simplicity the difference between high and low tax States is exaggerated, the degree of exaggeration is far from being fantastic. For example, a family with $15,000 in taxable personal income and $30,000 in real property in New York would pay income and property taxes to State and local governments amounting to about $2,000 on the average. In Texas, the average payment of a family with the same income and property would be only $300.

[7] The basis for viewing tax sharing in this way is the familiar (to economists) principle of opportunity costs. Tax sharing presumes that from the standpoint of Federal budgetary requirements, a tax cut has become possible. This tax cut foregone is the cost (which appears, in effect, as a tax at the State level) to the taxpayers of the tax-sharing plan.

in terms of the utility of private benefits foregone than the family in the low tax State. The national welfare (as measured by the aggregate of utilities of these two families) would be increased simply by reducing the Federal income tax, abandoning tax sharing, and permitting the two States to adjust their State and local taxes as they wished. Or, in a slightly different framework, reducing the Federal income tax and abandoning tax sharing would permit achievement of a Pareto optimal in which for *each* of the two taxpayers:

$$\frac{MU_s}{P_s} = \frac{MU_f}{P_f} = \frac{MU_c}{P_c}$$

where MU refers to marginal utility, P to price, and the subscripts s, f, and c refer to State and local public goods, Federal public goods and private consumption goods respectively. The tax-sharing plan would inhibit achievement of this optimal, or if we assume that it cannot be achieved anyway, it would shift citizens farther away from the optimal than they otherwise would be.

Moreover, if we were to assume that the high tax State was also one with a high average personal income (like New York and California) and that the low tax State was also one with a low average personal income (like Tennessee and Texas) then the inequity would be compounded further under the typical tax-sharing plan. For in the usual scheme, the Federal money is distributed among the States on a per capita basis, meaning that a relatively larger refund goes to the poorer States than to the richer ones. Even when this basic plan is modified, as in the proposal authored by Joseph A. Pechman, to give some weight to the "tax effort" of the different States, substantially more money, relatively, is returned to the poorer areas.[8] Despite being taxed more heavily, in the sense described above, New York would receive in Federal refund approximately 25 percent less than its tax contribution and California would receive 10 percent less, according to the Pechman plan. Texas and Tennessee, where citizens in the same income bracket were taxed much more lightly, would receive substantial surpluses, amounting to 50 and 75 percent, respectively, in excess of their tax contributions.

If we were to assume that these refunds were redistributed by the States to their citizens, in proportion to their contributions, then the $10,000 income family in the high tax State in our example would wind up with a net loss (since tax contribution in New York or California, as just shown, would be much greater than the refund), while the $10,000 income family in the low tax State would receive a bonus, or negative tax (since in Tennessee, for example, the refund would be some 75 percent greater than the tax). The net result, of course, would be to increase further the disparity in after-tax income between the families in the high and low tax States shown in table 1.

The major lesson of this section is that the tax-sharing plan treats people in the same income bracket differently, simply because of differences in their location, and this by any standard is inequitable.

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[8] See the analysis of the Pechman plan in C. Lowell Harris, *Tax Revenue Sharing with the States*, Tax Foundation, Inc., March 1967, table 1, pp. 16–17.

Furthermore, this deficiency is inherent in tax sharing. Attempts to escape it, by modifying the plan in one way or another, run inevitably into insurmountable difficulties of another order.

For example, it might be proposed to allocate refunds to the States in a manner deliberately designed to equalize the *net tax effort* made in each State; but this would obviously contradict the very objective of tax-sharing plans by directing the maximum refunds where the tax-effort was greatest and the need for revenue was least, and the minimum refunds, if any, where the need for revenue was most urgent. We perhaps need not mention other patent objections to this scheme, such as the magnitude of Federal funds that might be required to achieve even a rough equality in some index of net tax effort among the States, or how to measure "tax effort" in a way suitable for this purpose.

With perhaps somewhat more justification, it might be proposed that refunds for tax sharing be returned to the States in amounts strictly proportional to their Federal income tax contributions. If we also assume that the States would remain free, legally as well as morally, to restore these refunds on a proportional basis to their taxpayers, then the charge of inequity against the plan would have to be dropped. In effect, each State would be free to accept a reduction in Federal income taxes for its residents, or to devote the funds to State and local needs, as voters decided. But of course the scheme just described no longer really involves tax sharing. Indeed, its objectives would be more easily achieved by simply reducing the Federal income tax across the board and permitting the States to raise their own taxes if and as they wished. This would avoid the complication of refunds from Federal to State Governments, as well as the even more serious complication of refunds from the State governments to their residents in areas where additional public revenues were not required, or were not desired by the voters.

In short, an attempt to escape the inequities of tax sharing leads, logically, to the abandonment of tax sharing itself.

III. The Alleged Efficiency of Tax Sharing

The standard tax-sharing plan would take some given proportion of total Federal income tax receipts and allocate it, with no strings attached, so that poorer States receive more, and richer States less, in proportion to their contributions. Presumably, the scheme is designed to help equalize differences in public services among the States, on the key assumption that these spring primarily from variations in financial capability.

It is easy to demonstrate that this basic assumption is false. It is called into question, first of all, by much of the data already reviewed, showing that the States make very different use of the sources of revenue at their command and that these differences are related neither to their needs nor to their respective income levels. It is called into question by a review of State and local expenditures, which discloses huge variations that in many instances have nothing whatever to do with differences in income. It is, of course, possible to test more formally the proposition that State and local public services are limited

in the various States primarily by their respective financial capabilities. For completeness, we have done so, at least for the most important single segment of State and local expenditures, those on education.

Expenditures per capita on education, by States, was correlated with personal income per capita and with tax effort (as measured by the ratio of State and local revenue from own sources to personal income). The coefficient of multiple correlation was high: 0.83. The coefficient of partial correlation with respect to each of the independent variables was precisely the same: 0.76. Analysis of the total variance in educational expenditures per capita showed that tax effort and personal income per capita each accounted for approximately the same proportion—about one-third.[9] In short, tax effort is at least as important as financial capability in accounting for variations among the States in expenditures on education. The phrase "at least" is justified on the grounds that a better measure of tax effort than the one used would probably improve the correlation and throw more weight to this variable.[10]

Thus, the basic assumption underlying the claim for tax sharing's efficiency is false; and as a result, instead of having a corrective effect (at least, potentially), tax refunds would have a distorting effect on the relationship between tax effort and public benefits in the various States. This may be illustrated by a simple example.

Suppose that in a high tax State the marginal productivity of public expenditures is 100 and that the marginal utility of income is 200. The relationship between the two measures reflects the supposition that most of the urgent and important public services are already being provided, but at the expense of a heavy cost in taxes. Notice that taxpayers are not typically the direct beneficiaries of many of the most important optional public services. These go in significant measure to children, the aged, the unemployed, the disadvantaged, and the disabled. Hence, the ratio between the two measures reflects a high sense of public responsibility in the high tax State, in an era of heavy Federal taxes imposed by war. Suppose also that in a low tax State, with equal income before taxes, the marginal productivity of public expenditures is 200 and the marginal utility of money is 100.

Now a reduction in Federal taxes, if it became possible, would relieve the financial pressure in the high tax State so that the marginal utility of income might fall to 100, tending, we may suppose, to restore a peacetime equilibrium. In the low tax State, there would now be greater latitude for increasing State and local taxes; conceivably, the marginal productivity of public expenditures could decline to 100, restoring equilibrium here too. In contrast, tax sharing would have an asymmetrical effect. It would indeed improve the equilibrium in the low tax State by reducing the marginal productivity of public ex-

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[9] Specifically, the proportions were 34.2 percent for personal income per capita and 33.7 percent for tax effort. The multiple regression equation obtained was Expenditures on education per capita $= -169.5 + .0551$ (per capita personal income) $+ 1.42$ (State and local revenue per \$1,000 of personal income). All coefficients were significant at the 0.99 level. It is interesting to note that the simple correlation between the two *independent* variables was zero (specifically, the figure was $-.031$, insignificant even at the 0.90 level). Yet many models have been built on the assumption that these variables are negatively correlated. See, for example, James M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review*, September 1950, pp. 583–599.

[10] A full discussion of the deficiencies of the measure would carry us too far afield, but, briefly, it is apparent that the ratio of revenue to personal income takes no account of the *structure* of taxes.

penditures, assuming that the refund was put to appropriate use. But in the high tax State the disequilibrum would be intensified, with the marginal productivity of public expenditures dropping, say, to 20, while leaving the marginal utility of income unchanged. The sharp drop in the marginal productivity of public expenditures would reflect the fact that in this State the most important public services had already been provided. In any event, one net result of the disparate impact of tax sharing in the two States would be to provide a further (and uneconomical) motivation for labor and capital to move to the low tax State. The example reinforces a conclusion suggested in section II of this paper: tax sharing is biased in favor of the least responsible States.

The alleged efficiency of tax sharing may be faulted on additional grounds. Given the variations in attitude toward public responsibilities among the States, serious questions must be raised concerning the uses to which refunds may be put. Since no strings are attached, the money may be used for frivolous things as well as worthwhile purposes, or may even be used to reduce State and local taxes. Unfortunately, the tendency to misuse the funds in one way or another would probably be greatest in the least conscientious States, where the need for well directed public expenditures would be most urgent.[11]

Finally, the efficiency of tax sharing may be questioned on the basis of its use of the State as a unit for economic reckoning. Neither the number of people in a State, its average income, nor the two together can provide an accurate guide to its requirements for public expenditures. Thus, some of the most explosive problems of poverty are to be found in large cities, and some of these are to be found in the richest States. Tax sharing does not allocate funds in accord with such needs, nor does it even insure that the funds that are distributed will ever trickle down, through State legislatures often dominated by rural-suburban combines, to the urban centers. If one major objective is to help the poor, this can obviously be done more effectively by aiming aid directly at poor people rather than at some heterogeneous units labeled "poor" States.

IV. The Alleged Financial Crisis of the State and Local Governments

A very large part of the case for tax sharing, as ordinarily presented, rests upon the allegation that State and local governments face an imminent financial crisis. This dismal forecast is based upon two suppositions. First, it is assumed that the State and local governments have already exhausted the sources of revenue available to them—a proposition that was denied by the data presented in the first section of this paper. Secondly, it is assumed that the need for expenditures at the State and local level, even to maintain the present range of public services, is due to increase in the years ahead materially faster than revenue at present tax rates. It is not difficult to demonstrate that this second supposition, too, is almost certainly false. The basic pitfall that

[11] A case in point arose recently in Virginia. A State sales tax of 2 percent was imposed in September 1966 to raise money for aiding the counties in improving education. Perversely, some of the southern counties of the State, where educational standards (and also local taxes) were lowest, used the money for reducing county taxes.

led to the erroneous forecast resided in extrapolating the trends of the past decade, without appropriate change, over the decade ahead.

During the years 1955–65 three important factors promoted a huge expansion of expenditures at the State and local level. First of all, some backlog still remained in public facility requirements from the years of privation during the Great Depression and World War II. Secondly, the postwar baby boom resulted in increasing enrollments in public elementary and secondary schools by 35 percent. At the same time, the number of older citizens in the population, relatively heavy beneficiaries of health and welfare services, rose by 25 percent. All three of these conditions are due to change dramatically during the decade 1965–75.

The backlog of needs from World War II, now more than 20 years in the past, has long since been fulfilled. The birthrate reached its peak in 1957 and then declined; consequently, the increase in public elementary and secondary school enrollments is due to fall from 35 percent between 1955 and 1965 to 7 percent between 1965 and 1975. Between the same two decades, the rise in the number of older citizens in the population is due to fall from 25 to 17 percent.

As a result of these factors, mainly, the State and local expenditures required to maintain the present scope and quality of public services will rise by a much smaller amount in the decade ahead than in the decade just ended. The Committee for Economic Development estimates required outlays in 1975 at $98.5 billion, an increase of 32 percent over the 1965 total of $74.5 billion.[12] From 1955 to 1965, State and local expenditures had increased by 123 percent.

At the same time, the CED projected the net revenue yield to State and local governments, from the *existing* tax structure, at $119 billion in 1975.[13] Subtracting from this the projected expenditures of $98.5 billion leaves a surplus of $20.5 billion. In other words, the prospects are that the present tax structure will enable State and local governments not only enough to meet their obligation to maintain the existing range of public services, but also enough to improve the scope and quality of public services by about 21 percent above the level of 1965.[14]

Now of course such overall projections abstract from the many differences among the States. In some areas it may prove possible, and appear desirable to voters, both to improve public services considerably and also to reduce taxes. In other areas, the "need" for public services as perceived by the voters may outpace revenue and require an advance in taxes. As shown in section I of this paper, there is ample latitude for increasing taxes, if desired, in most of the States. Furthermore, it is likely that certain trouble spots, or certain branches of State and local services, will require and receive additional grants-in-aid from the Federal Government, as they have in the past. Such specific

[12] At 1965 prices. Although holding the price level constant, the CED did, however, make allowance for the fact that the prices of goods and services purchased by State and local governments have consistently advanced faster (by about 15 percent over a decade) than the price level for national output as a whole. See *A Fiscal Program for a Balanced Federalism*, Committee for Economic Development, 1967, p. 25.

[13] The $119 estimate is actually for "revenue available for general expenditures." The CED's projection of total revenue was $126 billion, but about $7 billion of this, it is expected, will be required for purposes other than general expenditures.

[14] This major finding of the CED is consistent in general with that of another research organization, Tax Foundation, Inc. See that organization's *Fiscal Outlook for State and Local Government to 1975*, New York, 1967.

aspects of future developments are obscured or ignored in aggregate projections. However, the projections do make abundantly clear that instead of a financial crisis, the State and local governments face an era in which revenues will tend to increase substantially in relation to the present range of needs. This situation will place a premium upon good judgment, responsibility, honesty, and technical administrative skills at these governmental levels. It is obviously one that will not, in general, call for extraordinary efforts to raise more money.

V. Some Aspects of Progressive Federalism

It is often alleged that the Federal Government is too big, and too far "removed from the people," so that its powers should in considerable part be turned over to the States. Assuming that this is so, it is important to note that agreement would not in any way strengthen the argument for tax sharing. On the grounds provided by the previous sections of this paper, the proper approach to adjusting the alleged imbalance of power would be by reducing Federal prerogatives and obligations and also reducing Federal taxes. The States would then have even more latitude than they now do to increase their own taxes, and of course would be able to occupy the areas of power vacated by the Federal Government, if they wished to do so.

However, the contention that power *ought* to be taken from the Federal Government and given to the States is arguable on many grounds. Here, brief comment shall be made on two aspects of economic history that would seem to justify an opposite proposal; viz, a further increase in Federal power at the expense of the States.

Interdependence.—The fact that the Federal Government's role in the social and economic life of the Nation has expanded enormously over the past century, and especially over the past 40 years, is due to several important and well known factors. One of these is the historical trend toward greater economic interdependence. In modern America, people throughout the Nation buy the same general brands of goods produced by the same giant corporations. The people of one State breathe the air, and traverse the rivers, polluted by those of another. The population is so mobile that the very phrase, people of a State, may be called into question. The roads as well as the education provided by any one State affects, and intimately so, all its neighbors. Population mobility, industrialization, and the spectacular advances in transportation and communication have, in short, bound the Nation into a cohesive whole. So much so, that barely any of the important economic or social problems of the day—be it auto safety or a business recession—can be solved by one State alone. These historical trends are not reversible. They promise that the Federal Government will grow stronger rather than weaker. Perhaps in the more distant future, they promise that a world government will grow at the expense of national sovereignties, though it is agreed in the light of present international affairs that this future may be distant indeed.

Federal Leadership.—In providing minimum social and economic standards, history suggests, the States not only have been led, but *must* be led, by the Federal Government. The instances are virtually numberless, from the Civil War itself to the enactment of Federal legislation

in 1938 protecting women and children in industry. Of course, it is true that some States have on occasion pioneered in social legislation. Three States had enacted laws to limit the hours of work of women and children nearly 100 years before the more comprehensive Federal Fair Labor Standards Act. But at the same time, the vast majority of States had lagged.

There is a basic reason why many States will always lag in adopting progressive legislation, and this is aside from differences in moral standards, educational levels, and such. This reason has to do with the competition among the States for industry. Some aspects of this competition are socially unhealthy and economically self-defeating. It may be so classified when it results in luring industry to one State rather than another by sacrificing values related to the welfare of the State's own people or of people elsewhere. For example, one State by itself may fear imposing regulations on its industry for limiting air or water pollution. Its hand is strengthened, and in fact this aspect of competition is eliminated, by Federal legislation imposing a general standard.

If anything, the use of such Federal prerogatives have been underemployed rather than overused. Federal standards for education—in the form of uniform, nationwide examinations to insure *minimum* accomplishments for primary and secondary school graduates—would probably do more for raising educational levels, where it is needed most, than further Federal grants at this stage. Such standards should indeed be tied to Federal aid.

It should be noted that the imposition and enforcement of Federal standards can often be coupled with less direct Federal administration and supervision. The same ends cannot always be achieved most efficiently in the same way everywhere, and diversity in method around the Nation would encourage innovation. But leadership, coordination, and perhaps above all, minimum standards, must be provided by Washington if they are to prevail at all. Perhaps nowhere are they needed more urgently today, especially creative leadership and constructive coordination, than in the programs related to welfare, public assistance, and poverty.

The insistence on Federal standards, especially where Federal money is involved, would also seem to be a prerequisite of good democratic government. Taxpayers, it is generally agreed, ought to have a say concerning the use of funds they provide, at least through their elected representatives. When this is denied, as in the tax-sharing-with-no-strings-attached plans, the result comes very close to taxation without representation.

TAX SHARING*

BY HARLEY L. LUTZ

PLAN RAISES DOUBTS ABOUT THE WHOLE FEDERAL GRANT SYSTEM

Republican leaders have been widely praised for their recommendation that the 90th Congress devise a plan for sharing Federal tax revenue with the States. But although their intentions are no doubt laudable, the unfortunate effect of the proposal is to obscure more fundamental questions.

Actually, the idea is not new. Certain miscellaneous receipts—fees for grazing livestock on Federal land, for example—have long been shared with the States in which the receipts originated. A few years ago a different version was suggested: The distribution of Federal excess revenue among the States. (This wasn't new, either. In 1836, after the public debt had been entirely paid off, a surplus was distributed.) This second scheme was hatched in the early days of the New Frontier, when the new economists believed that their fiscal policy would generate revenue much in excess of expenditures. Thus far, of course, there have been no surpluses.

The two devices—tax sharing and distribution of surplus—have in common the objective of assisting States and localities. They differ, however, in that the distributed surplus was to be a supplement to Federal grants and would have been available for general State purposes without Federal control. The shared tax would be allocated, according to its proponents, as an offset to Great Society programs authorized but not yet funded by Congress. In other words, this money would supplant the future increase in Federal grants that would otherwise be necessary to liquidate certain Great Society commitments.

GRANTS A FORM OF SHARING

Because the Federal Government has no significant sources of income other than taxation and borrowing, any money it passes to the States must come from one of these sources. Therefore the Federal grant system, from the beginning, has been a sharing of taxes and public debt receipts. The Republican proposal has been "slicked up" to look like a new policy by specifying that a fixed percentage of Federal tax collections be allocated among the States. Even so, however, it is expressly tied to the grant system.

So, a good idea of how Federal sharing has worked can be had by considering how the grant system has worked.

Supporters of the Federal grant system can point to many things that have been accomplished at a faster rate under its stimulus and

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assistance than might otherwise have occurred. The original idea was that welfare programs deemed to be in the national interest would thereby be inaugurated and, once launched, would be carried on by the States without further Federal support because of the general support and approval induced by their benefits. This expectation was never realized. Instead of a gradual withdrawal of Federal aid, it has mushroomed with no end to its expansion in sight.

Criticism of the grant concept has been rare. Objections have generally been directed at practical management aspects rather than at the underlying doctrine. State and local officials have complained, first, that Federal selection of programs does not always accord with their judgment of priority needs and hence that some distortion of their budgets is involved in accepting the aid; and, second, that Federal determination of standards, supervision of use and other regulations are unduly burdensome.

These complaints are to have sympathetic attention in the next Congress, but the legislative bickering will center on how to eat the cake and still have it. That is, it will be a question of how to keep the benefits of the grant system while reducing Federal control over it. The doctrinal aspects are not likely to be considered.

Adoption of the Republicans' tax-sharing plan, as outlined in press reports, would involve the Government in a serious inconsistency. One intention is that the funds be given with few or no strings attached, the chief condition being observance of constitutional requirements such as prohibition of racial discrimination. At the same time the main purpose of the handout is said to be replacement of Great Society programs. But these programs will involve Federal supervision and control. In other words, with no strings attached a State would be free to use the shared revenue for purposes of its own choosing, which might or might not be a Great Society program. One course would be tacit acceptance of Federal control and the other would amount to abandonment of a program to which the Government is already committed. The combination of a Federal grant without strings and a Federal policy of determining purposes of the grants is a logical impossibility.

STATES STILL DEPENDENT

Tax sharing is not likely to contribute to decentralization of governmental power. Even under a "no strings" grant, acceptance renders the States dependent on Federal bounty. The faucet can be turned off at will and the flow of money can be manipulated to penalize States that get too far off the Federal reservation. It is said that the country's mood is increasingly against Federal supervision and control. When popular resistance to Federal domination rises to a pitch that will impel the people to reject Federal benefits and insist that such matters as are proper governmental responsibilities be managed and financed at the State and local level, there can be decentralization of governmental power, but not before. This degree of popular resistance is not even above the horizon.

The underlying thesis of tax sharing is that the Federal Government is vastly superior to the States as a tax collector. Therefore, the argument goes, it should collect more tax revenue than is required

for Federal purposes with the understanding that the excess collection is to be returned to the States. The alleged superiority of Federal tax administration rests on severity of enforcement and high tax rates.

The severity is obvious, despite the annual assurance of the Commissioner of Internal Revenue of a desire to be friendly. The 18th century French Statesman Turgot said that a finance minister must have a certain ferocity and it would seem, at times, that this maxim had been taken here at full value.

Given a free field, the States, by imposing tax rates equal to the Federal rates, could collect as much revenue in the aggregate as does the Federal Government. But they do not have a free field. The Federal tax claim is a first lien on income and in the case of the estate tax, on accumulated wealth. Thus the vicious spiral mounts. High Federal tax rates prevent the States from imposing taxes at rates that would meet their requirements and so they need help; Federal grants provide that help; as the high Federal rates rake in the money greater State needs lead to more grants and to justification of a Federal tax levy sufficient to pay them. Federal taxes skim off the cream and the States are left with the skimmed milk.

In the beginning it was expected that the grant system would make a great contribution to a better life for all. Now Republican planners charge that the quality of American life across the board is deteriorating. The implication is that there is a kind of magic in the term "tax sharing" that will improve the quality.

A consensus on the meaning of "quality of life" would be difficult to achieve, of course. But the aspect of the indictment that concerns us is the significance of the grant system. Concretely, why has the increase of Federal grants from $1 billion in 1946 to over $13 billion in 1966 failed to make a better society? In what way have the grants been managed, or mismanaged, to contribute to this deterioration?

The launching, in rapid succession, of a large number of Great Society programs with more to come suggests recognition of this condition at the highest level. The immense variety of Great Society programs and the speed of their enactment indicate a desperate effort to reverse the decline, evidently on the theory that any program failure is attributable to inadequate funds. Nowhere in official circles, and among only a few in private life, is there recognition of the possibility that the grant system itself may be a major cause of the deterioration that an accelerating flow of grant money has failed to cure.

Any device by which the Federal Government undertakes to pay part of the cost of State or local government is certain to be demoralizing. Interference with local judgment and compulsory compliance with Federal standards, now said to be important sources of discontent with the existing grant system, are not the whole story. More subtle and more demoralizing is the illusion that Federal money is "free" money. The evil results are apparent:

First, a Federal program designed to serve real or fancied national interests may not accord with the judgment of State or local officials as to priority of needs, which would not be surprising in view of the great diversity of conditions among the 50 States. Yet the bait of "free" Federal money too often induces whatever distortion of State or local budget may be involved, with its accompanying frustration.

Second, "free" money tends to encourage extravagant and at times fraudulent diversion of Federal funds. It is a natural human trait to be more careless with money or property owned collectively by everyone and hence, in practice, by no one, than with one's own property or with money collected in the sight and with the knowledge of the taxpayers.

LAXITY ACCOMPANIES FEDERAL CASH

Laxity is well illustrated by the public assistance program. Here the Federal Government pays a part of the caseload cost as determined by an apportionment formula. Its share ranges from one-half to three-fourths or more, depending on, among other things the income ranking of the States. Eligibility standards for such assistance are determined by the States. These standards have been much less strict in the low-income States where the Federal share is highest than in other States where the Federal share is no more than half the caseload cost.

Cases of fraudulent diversion have come to light. It appears the practice has been especially common in the case of the highway grants, the Federal share of which is 90 percent.

Third, the grant system has greatly helped the Federal Government extend its power over governmental functions that were previously responsibilities of State or local government. It has, in effect, bought this extension of power over State and local affairs by its offers of grants-in-aid. The Federal squeeze on revenue resources has kept the States and cities in a relatively weak bargaining position in which they have had little choice but to accede to the Federal intrusion, even if they had been immune to the lure of free money. An illustration, recently reported in this newspaper, is the strategy of the head of the Department of Housing and Urban Development aimed at softening congressional opposition to the "model cities" program. It is said to involves the addition of other cities to the original list of 60, to develop pressure from more sources in support of the program.

From the beginning a chain reaction has intensified proliferation of the grant system. As results fell short of expectations and prophecies, more grant programs were devised and more agencies or subagencies were set up to operate them. There have been both inter- and intra-departmental power struggles to get or keep control, and all kinds of pressure tactics have been employed. A new type of professional has developed in Washington whose expertise is in advising States and communities regarding the kinds of grants for which they are eligible and the amounts of money they can obtain.

Confusion, duplication and overlap are characteristic of a government too big to be managed efficiently. The grant system has provided an excellent opportunity for the development of this well-nigh impenetrable administrative jungle. In some cases administrative costs absorb more than half of the available funds.

Instead of tax sharing by the roundabout route through Washington, the right kind of tax sharing would be a simultaneous phasing out of Federal grants and a reduction of Federal taxes. This would be a real sharing of the Nation's pool of taxable resources, and it would reduce and eventually eliminate the dependence of States and localities on Federal assistance. Breaking the vicious circle of high taxes and

large grants would accomplish more to improve not only the quality of American life but also the quality of government at all levels than further pursuit of the present policy.

The initiative to this end lies with Congress and the executive branch, and the chief opposition is likely to come from vested interests and departmental empire builders in the Government itself. No one can be proud of the conditions these influences have been so instrumental in creating. It remains to be seen whether the changed political alinement in the 90th Congress will be adequate to focus the debate on the fundamental rather than the superficial aspects of the grant system.

SHARING REVENUE WITH THE STATES*

BY LEON H. KEYSERLING

Under the banner of the "new economics" these past 6 years, we have made important changes in national economic policies. And because an appraisal of these policies sheds light upon the proposal to share Federal revenues with the States, I want to point out what has been happening.

After the 1960–61 recession, the upturn of 1961–63 started rapidly and then slowed down greatly. Largely because of the massive tax reductions in 1964, the growth rate shot up for a brief period. But from first quarter 1966 to first quarter 1967 (estimate), the annual rate of growth in real terms fell to about 3 to 3½ percent, which I call a stagnation rate. Weaknesses appeared in many important sectors of the economy, and the most responsible forecasts for 1967 are not reassuring. Whether another recession is in the offing within a year or so is not clear, but the threat is real.

Our full-time unemployment rate (by no means a measure of all forms of unemployment), is still sticking tenaciously close to 4 percent, the "interim" official target of 6 years ago. This is at least one-third higher than would be compatible with full employment. A 4 percent nationwide average unemployment rate also inevitably means a rate several times as high as this average among vulnerable groups (*i.e.* Negroes). A growth rate averaging considerably above 6 percent during 1967 and 1968 would be needed to restore maximum employment by early 1969; and to maintain it thereafter, an average annual growth rate of about 5 percent. The imperative tasks at home and abroad should lead us to reject an economic growth of only 4 percent and a full-time unemployment rate of about 4 percent, both of which the Council of Economic Advisers now forecasts for the years immediately ahead, and indeed espouses.

Over the next 10 years, a 5 percent average annual economic growth rate (contrasted with a 4 percent rate) would yield an *annual average* of about $50 billion *more* in real national production. This $50-billion is about two-and-one-third times the cost of the eight great domestic programs in the fiscal 1968 Federal budget—housing and community development; natural resources; education; health services and research; labor, manpower, and other welfare services; public assistance; the economic opportunity program; and agriculture and agricultural resources (47 percent of all farm families live in poverty, contrasted with 17 percent of nonfarm families). The outlays for

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these eight programs in the fiscal 1968 Federal budget are estimated at only 2.70 percent of our total national production, contrasted with 2.73 percent in fiscal 1967. Federal expenditures for education have been cut back from $3.3 billion in fiscal 1967 to $2.8 billion in fiscal 1968 (cut back even more in real terms, in view of rising prices). Expenditures for housing and community development, despite the hue and cry about our cities and the almost one-fifth of our people who still live in slums, are lifted from $0.9 billion in 1967 to only $1.0 billion in fiscal 1968 (also a reduction in real terms, due to rising prices), and still come to far less than 1 percent of the Federal budget.

Directing primary public attention to Federal revenue sharing is a mere academic exercise, until it is first brought home to the Nation and to the Federal Government that tremendous increases in public spending are infinitely preferable to more tax reduction or unwarranted devotion to a balanced Federal budget. This battle must be won *first*, and the fiscal 1968 Federal budget indicates that it is not even being fought.

The philosophy underlying the massive tax reductions, mostly in 1964, was that economic growth was too low because aggregate demand was too low, and that tax reductions without corresponding cuts in Federal spending would appropriately increase aggregate demand. But this simplistic analysis neglected *resource allocation and income distribution* which are really the core concern of all economics. The result was a recurrence of imbalances now everywhere apparent.

The "new economics" has not only failed to weigh the relative value of increased public spending and tax reduction; it has erred in not recognizing the importance of the *internal composition* of Federal spending and taxation. It is palpable that some types of public spending contribute more than others to growth and our well-being. The tax reductions of 1964, by allocating far too much to stimulation of investment in plant and equipment, and far too little to stimulation of consumption, aggravated the maladjustments which explain the serious deterioration in the entire economic performance since about a year ago. The administration's very recent suggestions to restore the 7 percent tax credit to *stimulate* the economy by encouraging investment, accompanied by its continued advocacy of the 6 percent across-the-board tax increase to *restrain* the economy (with the major impact upon consumption) are vivid illustrations of gross inconsistencies. The combination of these two measures would compound the unfortunately regressive nature of the 1964 tax cuts.

Now, it is urged in some quarters that we pause to "digest" the whole hodgepodge of Kennedy-Johnson programs which have been started, before we attempt much else. But if a man is stricken with appendicitis and one doctor is treating his ears and nose and mouth and toes, it is not enough for another doctor to advise "digesting" all this before starting surgical action at the right spot. We have far too many *programs* because we have no one program.

We sorely need, under the Employment Act of 1946, a full-scale program which budgets our resources and requirements for 10 years ahead, and then puts into effect, and in concert, those policies that will take us where we want to go. The work of the Council of Economic Advisers under the Employment Act has hardly reached the threshold of this central task, and until we cross it we shall continue to fly blind. Complaints about "big government" and "excessive concencentration of power," notwithstanding, we cannot move ahead without much more emphasis on the unifying influence of larger and better directed *national* effort.

I am against the proposal to share Federal tax revenues with the states, without any significant standards or "strings" as to how these shared revenues shall be used. It erroneously assumes that, granted increased reliance upon the taxing powers of the Federal Government, our national purposes would be served better if more of the decisions about the purposes for which federally collected revenues are to be spent were made by the 50 States.

This entire question of revenue-sharing arises because our economic growth will, within a few years, yield large increases in Federal income, even at existing tax rates. I estimate that during the decade ahead about $550 billion *more* in Federal taxes would be collected at an optimum growth rate.

The main architect of the shared-revenue idea, without tight "strings," is Walter W. Heller, former Chairman of the Council of Economic Advisers. He outlines the plan with customary discernment in his recent book, *New Dimensions of Political Economy*. In explaining my reasons for opposing it, I shall be referring to Dr. Heller's arguments in its favor.

Dr. Heller says: "At the Federal level, economic growth and a powerful tax system . . . generate new revenue faster than they generate new demands upon the Federal purse." But if the "demands" have lagged, it is only because the needs of the Nation have been insufficiently appreciated. Dr. Heller feels that revenue-sharing without "strings" would reduce opposition to greater public spending for domestic purposes. I see no reason to believe that. Those who traditionally object to public spending because of its tax implications, or because it is "inflationary," or because "public housing competes with private enterprise," will not be any the less antagonistic if the States were to spend more of the federally collected money.

The great issue, as I have said, is not only the *total* level of public spending, but its *allocation*. This determination can be much better made by the Federal Government than by 50 States which, under the revenue-sharing plan, would be subject to no substantial Federal standards. To make clear the towering importance of this point, the following table shows my own projections for a Federal budget that would be genuinely responsive to our resources and our national needs.

Goals for a Federal budget through 1976

[In fiscal 1968 dollars] [1]

	Fiscal 1968 actual			Calendar 1970 goals			Calendar 1975 goals		
	Total (billions)	Per capita	Percent of GNP (estimated)	Total (billions)	Per capita	Percent of GNP	Total (billions)	Per capita	Percent of GNP
All Federal outlays	$135.033	$673.54	16.67	$150.5	$720.10	15.67	$173.0	$765.49	14.12
National defense, space technology, all international	85.584	426.89	10.57	86.4	413.40	9.00	97.7	432.30	7.98
All domestic programs	49.449	246.65	6.10	64.1	306.70	6.67	75.3	333.19	6.15
Housing and community development	1.203	5.10	.13	3.8	18.18	.40	4.2	18.59	.34
Natural resources	3.518	17.55	.43	3.9	18.66	.41	4.5	19.91	.37
Education	2.816	14.05	.35	7.8	37.32	.81	10.6	46.90	.86
Health services and research	4.767	23.78	.59	5.4	25.84	.56	7.8	34.51	.64
Labor, manpower, and other welfare services	1.641	8.19	.20	2.9	13.88	.30	3.4	15.05	.28
Public assistance	3.036	15.14	.37	4.5	21.53	.47	5.0	22.12	.41
Economic opportunity program	1.860	9.28	.23	3.3	15.79	.34	4.5	19.91	.37
Agriculture and agricultural resources	3.173	15.83	.39	7.8	37.32	.81	8.9	39.38	.72
8 selected domestic priority items	21.834	108.91	2.70	39.4	188.52	4.10	48.9	216.37	3.99

[1] To the extent that the general price level in later years advances above the fiscal 1968 level, the dollar goals for calendar 1970 and 1975 would need to be increased accordingly. The table is based upon the administrative budget, because the details set forth cannot be as effectively stated in terms of the cash or national accounts budget. But conversion of the table into a cash or national accounts budget would not significantly alter the import of the table.

The table is developed within the framework of an economy that is growing at a pace sufficient to restore and maintain maximum employment and production. The Federal budget it proposes would not intrude excessively upon private enterprise, or upon the traditional functions of States and localities; the table indicates that the ratio of *total* Federal outlays to GNP would in fact gradually decline, even though the ratio representing the eight great domestic priorities would increase. While allowing liberally for increasing outlays for national defense, space technology, and all our international obligations, it would also cover Federal outlays for our basic domestic requirements. If put into effect, it would result, by 1975, in the virtual liquidation of poverty; in decent homes for almost all our families and immense progress toward urban renewal; modern health services for all, at costs within their means; educational opportunity for all, up to the limits of their ambitions and capabilities, at costs within their means; modernization of obsolescent transportation systems; a specialized attack upon the private poverty and the paucity of public service in rural areas; conservation and replenishment of national resources, including treatment of polluted air and waters.

Although the table does not specifically refer to the guaranteed annual income, its allowance for various welfare programs would be sufficient to support this scheme, as it gradually replaced some of our highly deficient welfare programs. The total outlays also allow several billion dollars a year for federal contributions to larger payments under the Social Insurance programs, in lieu of expansion of regressive payroll taxes.

In my judgment, the Federal Government is not only in a better position than the States to allocate public spending, it is in a stronger position to resist unwholesome pressures toward diversion of tax money to the *wrong* purposes. Of course, the Federal Government's record has not been perfect in this respect. Federal assistance that began in aid of rehousing slum dwellers, has come to starve this purpose and to devote an excessive portion of available revenues to "urban renewal" projects. These projects tear down substandard housing, only to force the occupants into other substandard housing at higher rents. Meanwhile, the Government has subsidized the acquisition of land, at reduced costs, for glittering commercial and industrial edifices of those who do not need this public help so much, or do not need it at all.

But there is scant evidence that the States would do better if they had federally collected revenues to spend as they wished; on the contrary, the misdirection of Federal efforts in this field has been due principally to too much reliance upon State and local officials. My own studies in some of our largest cities have convinced me of this. For instance, public expenditures for those encircling highways which enable affluent suburbanites to move more easily from their homes to their offices in the city have been excessive in ratio to resources devoted to the schools, hospitals, police, and rehousing for the less affluent and poor.

Take another example. In 1935 the Old Age Insurance System was established on a unified basis. It has not expanded enough, because the Federal Government has not put into it enough resources out of progressive taxation, but instead has relied upon regressive payroll taxes. But this unified national system is a wonderland, compared with the

blunderland of 50 separate unemployment insurance systems established under the same 1935 act. The pauperizing and degrading—and not only because of inadequate funds—by many states and localities of those who are dependent upon welfare systems not subject to Federal standards, has become a national disgrace.

Dr. Heller says that his revenue-sharing scheme would interfere only slightly with meeting our great nationwide priorities, because it would absorb only a small portion of the *total* Federal budget—about $6-billion a year at its peak. But this $6 billion is almost 28 percent of Federal outlays of less than $22 billion in the fiscal 1968 budget for the *eight great domestic priority programs* which I have listed. The $6 billion a year would be approximately sufficient to finance a full-blown nationwide guaranteed annual income (in the form in which I described it last week).

Dr. Heller argues for revenue sharing on the ground that it would deflate the influence of powerful "private interest groups and pressures" which converge upon *ad hoc* programs of Federal spending. I am sure that the "pressure groups" will be there, *wherever* the choices among various spending programs might be made. And I am doubly sure that those "pressure groups" which usually represent the public interest have a relatively better chance to be heard in Washington than in the State capitals. The reverse is true of those "pressure groups" which are inimical to the public interest and which operate largely under cover.

Any plan for revenue sharing, legislated by the Congress, is likely to rely very substantially upon the relative populations of the States; and some of the more heavily populated States are among the most affluent already, even on a *per capita* basis. A revenue-sharing plan is also likely to be related in some respects to the amount of Federal revenues collected from the respective States; indeed, this is at least implied in the word "share." The adverse impact of this upon the principle of "equalization" (through Federal allocation of spending in accord with need) is obvious. Federal spending of the revenues the Federal Government collects likewise assures more flexibility in dealing with the unemployment problem, because projects employing labor may be more easily directed to areas of the country where unemployment is most serious.

Dr. Heller points out that one-sixth of our total population in each decade changes its State residence, and that the whole Nation therefore has an interest in the health and education of a child born in any State. Agreed. But I cannot understand his use of this fact to support revenue sharing. The more we become *one* Nation rather than *50* States, the more our economic and social problems require national treatment.

RESTRICTING FEDERAL FISCAL FLEXIBILITY

Theoretically, it might be urged that revenue sharing would still permit the Federal Government to determine the total amount of Federal taxation relative to the total amount of public spending of federally collected revenues (whether spent by the Federal Government or by the States). But this opportunity would be diminished, insofar as

the Federal Government loses control of a large portion of the spending of the money it collects. Indeed, Dr. Heller says that the revenue-sharing plan should be contractual, and independent of the surplus or deficit position of the Federal budget. I cannot fully understand why he, an avid exponent of the increased use Federal fiscal flexibility in aid of nationwide economic stability and growth and to combat inflation, should favor a plan which would restrict this flexibility.

The "new economics" has often recommended that Congress delegate to the President the power to make quick changes in tax rates. Sufficiently quick adjustments in the impact of overall fiscal policy upon the economy depend upon closely coordinated use of two weapons—taxing and spending. Vesting in the States an unrestricted responsibility for spending a sizable and growing portion of what Federal Government takes in would work against this objective.

The size and composition of the Federal tax burden have powerful effects upon income distribution. Similarly, the size and composition of spending supported by Federal revenues needs to take increased account of the need for more *ad hoc* spending to supplement the incomes of the poor. One example of this is the large contribution, supported by progressive taxation, which the Federal Government should make toward lifting the benefits under the OASDHI system. Two-thirds of our senior citizens are poor, President Johnson's later proposals to increase benefits are inadequate, and the financing of these benefits is regressive.

I cannot see any administratively feasible way for the States to undertake, with comparable results, such income-support programs. Nor do I believe the States would place sufficient stress upon this approach.

The needed increases in total public spending are so vast that *both* the Federal Government and the States need to do more than they have been doing. Dr. Heller says that revenue sharing, by lightening the burden on the States, would mitigate the trend to (mainly regressive) increases in State taxes. This implies that the States would use what they get from the Federal Government in part to reduce the rate of growth in revenues collected by the States, so that the net increase in public spending would be *less* than if the Federal Government spent the money itself.

Further, I can see no reason to think that revenue sharing would encourage the States to make their tax systems less regressive. The progressive nature of the Federal income tax has thus far been a decisive counter to the regressive nature of State and local taxation. If Federal fiscal policy is to be used to improve the nature of taxation at lower levels, and to increase the tax take at lower levels (both proper objectives), the workable approach would be to use the Federal taxing power or the Federal spending power, or both, to *induce* such trends.

Although Dr. Heller in the past has made suggestions in this vein, he hardly accents them in his book. And anyway, if Federal fiscal policy were used to induce or "coerce" the States to reshape their fiscal policies, this might be said to interfere with the "freedom" of the States, and would thus run counter to the enlarged "freedom" of the States which Dr. Heller favors.

I regard as meretricious the view that State governments are "closer to the people" than the Federal Government, and thus more responsive to their real needs. It has not been true to date, and I cannot share Dr. Heller's optimism when he says: "As an article of *faith* (italics supplied), I count rather heavily upon reapportionment to achieve equity in the allocation of funds within the States." This statement seems to me more a confession of what has actually been happening than a realistic hope for the future. Nor can I accept Dr. Heller's barbed comment that the revenue-sharing plan should be adopted because there is not enough wisdom at the top to deal with admittedly nationwide problems. The issue is not *where* taxes should be collected and applied to public purposes, but rather how federally collected revenues should be spent. If the States want to do more, they should tax more.

SPENDING WITHOUT "STRINGS"

The American people watch what their National Government and its leaders are doing much more closely than they watch what their State governments are doing. Even of this could be changed—and I do not think it could be—*it violates every principle of good government that 50 States should spend without standards or "strings"* the money that one government collects. To be sure, we *do* need to develop State and local responsibility. But insofar as the spending of revenues collected by the Federal Government is involved, this can be achieved through Federal grants-in-aid. These I entirely favor, with appropriate modifications and expansion. They permit considerable flexibility, and even from the standpoint of administrative costs are at least as economical as revenue-sharing, without its attendant liabilities. It is perfectly feasible to combine a Federal hand in the spending of the money which the Federal Government collects with using State and local administrative instrumentalities (including advice), as well as quasi-public and private instrumentalities.

Moreover, the application of the grants-in-aid principle, in contrast with revenue-sharing with the States, gives the Federal Government much greater leeway in deciding whether the cities, or the States, shall spend federally collected revenues. Dr. Heller appears satisfied to leave the cities to the mercies of the States. Yet we know how often this has worked badly, especially because State legislatures in many instances are grossly nonrepresentative of their populations. The answer that political reapportionment will take care of all this in time is too facile. At best, it will take many years before reapportionment can achieve throughout the Nation the purposes toward which it is aimed. And even then, it should be directed mainly toward improved allocation by the States of the revenues which they themselves collect.

Apart from all this, with respect to these programs closest to the great priorities and social justice, there are grave unresolved issues as to the proper balance between the relative effectiveness of dealings between the Federal Government and the States, and dealings between the Federal Government and the cities. These issues should not be prejudged; they should be left open to determination in the light of unfolding experience on a pragmatic basis.

In an important sense, the revenue-sharing plan does not address itself to improving the allocation of power and responsibility between Federal Government and the States. For revenue sharing would *per se* involve no change in the ratio of Federal tax collections to State tax collections, and no change in the ratio of public services paid for out of Federal tax collections to total public services.

Here I think I should remind the reader that the Federal Government is *not* "taking over." From 1955 to 1965, State and local expenditures rose 125 percent, while Federal outlays rose only 65 percent. In 1965, the State and local share in total spending for civilian purposes was 77 percent; the Federal share, only 23 percent. Even if grants-in-aid were to be treated as Federal rather than State or local expenditures, the ratio in 1965 was about 2 to 1 in favor of the States and localities. In 1964, the ratio of Federal taxes to total national production was 14.4 percent, representing the lowest ratio since World War II. Of course, if taxation in support of defense spending were to be excluded, the ratio of Federal taxes to gross national product is much lower than the State ratio.

The central point in all this is that the revenue-sharing plan without standards or "strings" represents essentially the same errors which have been deeply embedded in the policies of the "new economics." These errors are founded upon the proposition that Federal fiscal policy should concern itself with the *aggregates* of taxation and spending and manipulate these from time to time, but should be "neutral" by paying relatively less attention to the resource allocation and income distribution aspects which are essential to optimize our economic performance, meet the great priorities of our national needs, and enlarge social justice. So long as these errors persist, they lead naturally to the conclusion that it does not make too much difference *who* actually spends the money, even though this affects the *purposes* for which the money is spent. These errors also lead, under the guise of appropriate "decentralization" and "sharing of responsibility," to excessive dispersion of responsibility, cross-purposes, and waste.

FEDERAL GRANTS AND THE DECLINE OF THE FEDERAL SYSTEM*

BY ROGER A. FREEMAN **

The growth rate of Federal aid to State and local governments is virtually unparalleled in our fiscal history. From $7 million at the turn of the century it soared to about $1 billion in the midthirties to midforties, and to nearly $14 billion in the current year. On the average the amount tripled every 10 years and almost quadrupled in the past 10. Even more startling is the multiplication of program which now cover most major domestic public services, with the few remaining gaps being rapidly filled. Continued expansion was foreshadowed at the first session of the 89th Congress which wound up its work 2 weeks ago. For once, academic advice, presidential recommendations, and congressional action appear to be in harmony and point in the same direction. When the Joint Economic Committee earlier this year gathered the views of 48 economists on "Fiscal Policy Issues of the Coming Decade" most of those who referred to Federal-State relations suggested an expansion of Federal grants in some form or other. None disagreed. The last time I heard a plea for greater financial self-reliance by local governments was in 1964 during a study trip through the Soviet Union when I read an article by two Russian ecoonmists who, writing in an economic journal, suggested that local units ought to try to depend less on support from the budgets of higher governments.

It is remarkable that the U.S. Government was able to multiply its grants—and other domestic activities—without significantly changing the ratio between total Federal spending and the gross national product over the 14 years, as President Johnson pointed out some time ago. It did so by a sharp relative cutback in defense outlays which meanwhile dropped from 66 percent of total Federal spending to 42 percent. That retrenchment in national security provided the leeway for a dramatic expansion of civilian public services which seems to have far from runs its course.

The steadily swelling flow of Federal funds into local channels has enjoyed wide popularity but, as any rapid growth, has also caused some dislocations, friction, administrative or political problems, or even unhappiness among less favored groups. General opposition focused particularly on the charge that the spectacular expansion of Federal grants to State and local units is leading to a centralization of governmental power at the expense of home rule, local autonomy, and individual freedom.

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But Federal grants thrive on opposition. A joint conference of representatives of Congress and the Governors' Conference in August 1948, concerned over the postwar growth of Federal grants to over $1 billion, recommended that amounts for fiscal 1950 be cut by no less than 20 percent. As it turned out, grants in 1950 were not 20 percent smaller but 34 percent larger and kept on climbing. Two years later a new administration assumed office which was troubled by thhe apparent trend toward a power monopoly at the national level and set about to reverse it. Following suggestions by Senator Robert A. Taft, it prevailed on Congress to form a study commission "because the activity of the Federal Government has been extended into many fields which, under our constitutional system, may be the primary interest and obligation of the several States . . ." In his 1954 budget message the President said: "This budget marks the beginning of a movement to shift to State and local governments and to private enterprise Federal activities which can be more appropriately and more efficiently carried on in that way."

The creation of the Commission on Intergovernmental Relations was heralded by some of its friends as the Second Coming of the Constitutional Convention and expected to help stem the tide of Federal power—or according to others try to turn back the clock of history. but when the Commission rendered its report 2 years later it was obvious to friend and foe that the world would little note nor long remember what was said here. The New Yorker would have placed the "on one hand . . . but on the other hand . . ." report in its department of anticlimax if it had mentioned it at all, which like other media, it did not. As it was, the Commission succeeded during its short life and in the thereafter in attaining a degree of anonymity which the Central Intelligence Agency envied and has ever since been trying to emulate.

Federal grants meanwhile soared to $7 billion in 1960 and totaled almost $14 million in the President's recommendations of January 1965. Back in 1960 I discussed in my book "Taxes for the Schools," the remarkable fact that Federal grants tripled during the life of an administration which was committeed to cutting them and wondered aloud "how fast Federal aid and Federal activities in general will expand in the future if an administration comes to power that favors them." The record of the past 5 years has answered my question.

THE FISCAL MISMATCH AND THE NEED FOR FEDERAL AID

The classic and most frequently advanced justification for Federal grants—and for far larger grants—is inadequate fiscal capacity of State and local governments or what Walter Heller recently called the "fiscal mismatch": State and local governments are responsible for most domestic public services whose needs are exploding while the National Government has preempted the most lucrative revenue sources. U.S. Treasury tax receipts, the story goes, expand with the economy and at a faster rate while State and local revenues are sluggish and grow only slowly. The record proves this to be true during every shooting war, from 1916 to 1920, from 1941 to 1945. But during peace peri-

ods, before and after every war, the opposite has been true. In the past 20 years GNP grew 203 percent, Federal revenues 135 percent, State and local revenues (from their own sources) 434 percent. This was of course due to the fact that Federal tax rates were cut (ever so slightly) while State and local tax rates were raised. So, now the case for more Federal aid has to be slightly modified: State and local governments, by quintupling their tax receipts have overexerted their fiscal powers and exhausted their capacity. This gives us two compelling reasons to prove the need for a sharp expansion of Federal grants: State and local tax revenues rise (a) too slowly, (b) too fast. Some observers feel that this is a "heads I win, tails you lose" proposition.

Federal financial assistance is also needed, we are told, because State and local governments are hamstrung by obsolete constitutional limitations which prevent them from exercising adequate taxing and borrowing powers. Those tight and unreasonable restrictions do not seem to have stopped State and local governments from boosting receipts (from their own sources) from $13 to $71 billion in the past 20 years or from pushing their outstanding debt from $17 to $92 billion. So, again, the case for Federal grants had to be slightly modified: State and local debt grew 428 percent in the past 20 years, Federal debt only 16 percent, which apparently proves that State and local governments are dangerously overexpanded while the Federal debt has shrunk in relative terms and Federal borrowing capacity is underused.

Strangely enough it is never mentioned in that connection that Federal debt soared 1,283 percent in the preceding dozen years while State-local debt declined 9 percent or that Federal and State-local debt were of approximately equal size three decades ago while today Federal debt is three times larger than State-local.

Now I am not quoting those figures in an attempt to prove that more Federal aid is needed or that it is not needed. That may depend on other considerations. I only want to throw light on the statistical acrobatics which are being widely used to present a one-sided and distorted picture of the record of Federal and State-local finance. Even the originators of new grant-in-aid programs do not seem to believe that State and local governments are at the end of their financial ropes: they almost always include matching formulas which call for sizable State and local contributions and often provide incentives for boosts in the spending of local funds. Such stimulants would serve no purpose if State-local governments had no remaining fiscal capacity. Several students of the subject such as Dick Netzer and Arthur Smithies have indeed concluded in recent reports that State-local governments are far from having exhausted their fiscal potential.

The 1950's and first half of the 1960's were characterized by continuous rounds of tax boosts at State and local levels which, to the taxpayers' chagrin, refute the snide remark of the American Assembly in October 1955: "Zeal for new tax levies is not characteristic of State legislatures." More than half the States enacted substantial tax boosts in 1963 and about two-thirds did in 1965.

But to boost taxes is a political hazard for the Governor, mayor, legislator, or local functionary who must run for elective office while a new Federal grant program only bestows credit and earns gratitude for the public officials, Federal, State, or local, who enact the program

or distribute its benefits. In the common folklore Federal money comes "for free," a very comforting thought which parallels the reasoning of the patient who told his psychiatrist that he was making long-distance calls to himself. "Isn't that expensive?" inquired the doctor. "No, it doesn't cost a cent," said the patient, "I am reversing the charges."

There is eternal glory (and political profit) in being the author of something akin to the Morrill Act, Hill-Burton Act or George-Barden Act which initiated major Federal grant programs. But whoever heard of a tax bill named after those or any other legislators at any level of government? Small wonder that elective officials increasingly find Federal aid more conducive to political longevity and thus more attractive than boosting a local tax. Charles Conlon remarked at the 1952 Tax Conference in Toronto that "The taxes which somebody else levies and you spend are of course the most desirable kind."

But there is something more to the distinction between "desirable" and "undesirable" taxes. A major share of federal revenues comes from the progressive personal income tax while the bulk of State and local funds is derived from taxes which are either proportional or even regressive. To be sure, if we allocate all taxes and all public expenditures by income brackets and relate the two—a study which unfortunately has not been undertaken for several years—we may be driven to the conclusion that government is primarily a huge machine for the redistribution of income. But, maybe, it is not doing enough of it.

Though the difference in incidence of Federal and State-local taxes may not be as great as is often imagined or asserted, there undoubtedly is a different impact upon various economic groups. Consequently those who feel that redistribution of income—from those who earn it to those who yearn it—is a major purpose and virtue of a tax system, or of government as such, favor financing through the National Government and abhor the growth of State and local taxation. Moreover they are steadily at work—and were successful in the Revenue Acts of 1964 and 1965—in making the Federal tax system more progressive. They are presently hard at work in preparing further revisions of the same type. Obviously, it is far easier to engender enthusiasm for a new program if the potential beneficiaries can be told (or at least made to believe) that somebody else will foot the bill. Small wonder then that Federal grants possess a political charm for officeholders and officeseekers, for prospective recipients and for many local taxpayers which is overwhelming and decisive—as their spectacular record proves.

Alternatives to Programmatic Grants

The National Government could, of course, financially aid State and local governments by means other than programmatic grants. Some of those devices have been drawing attention in recent years. One plan which according to recent newspaper stories is now under active considerations in the Treasury Department would grant credit on the Federal income tax for a percentage of State personal income

taxes. This would soon force the 14 States which levy no such tax to impose it and cause others to boost their rates. That may well be the plan's real aim.

Credits on the Federal income tax could provide broader and more effective aid to State and local governments if they extended to *all* taxes rather than single out the State income tax. Or, the credit device could be tailored to favor priority programs such as education. At hearings of the Senate and House committees studying means of aiding the schools—and, according to announcements giving relief to the property taxpayer—earlier this year I suggested to grant an income tax credit for school property taxes. Another way of helping particularly higher education would be the granting of income tax credits for tuition, charges, and gifts which I recommended to several congressional committees in 1963.

Other plans would allocate a small share of certain federally collected taxes to States. The House of Representatives in fact twice passed such programs but rescinded them soon after. Redistribution of Federal taxes to States (or also to local governments) would make funds available for the financing of public services at local discretion. Such plans of general subvention or tax sharing are widely used to distribute State-collected taxes to local governments, and also in several countries of the British Commonwealth. The United Kingdom adopted a system of general grants to local authorities in 1958. The U.S. Government however has so far extended its "cooperative federalism" only to spending programs and not to taxes.

General Federal grants to the States attracted little attention in the United States until Walter Heller, while still Chairman of the Council of Economic Advisers in the summer of 1964, advanced an idea which has since become known as the "Heller plan." A Presidential task force was summoned which endorsed the proposal in a report which was never made public but whose essential features can be gathered from several speeches by the task force chairman, Joseph Pechman, in 1965.

Senators Jacob Javits and Vance Hartke introduced a bill (S. 2619) to implement the Heller plan on October 11, 1965. It would distribute 1 percent of the personal income tax base, or about $2.5 billion a year, among the States, 80 percent in proportion to population and the remaining 20 percent to the 12 or 15 States with the lowest per capita income. Companion bills are pending in the House.

The "Heller plan" found a friendly reception among State Governors. Management and labor as represented by the NAM and the AFL-CIO agree on the Heller plan (and those groups are not very often on the same side of major policy proposals); they both are against it. The NAM believes that the pleasure of spending public money should be tied to the pain of raising it (as the State Governors once expressed it) and that in any case priority should go to cutting taxes and restraining public spending. The AFL-CIO feels that it wields more power in Washington than in some of the State capitols and that it can advance its goals better by a centralization of program decisions.

The Federal departments administering major Federal grants—HEW, Labor, Commerce—and the Treasury Department also voiced

vehement objections to the Heller plan and prevailed upon the President to keep it under wraps where it still rests and may well remain. Nationally organized functional interest groups in welfare, health, education, etc., the most effective driving forces on Capitol Hill which are responsible for the enactment of most existing Federal grants, are dead set against general grants. They are committed to advancing their own programs and do not want to dissipate decisions on the spending of the moneys to 50 State capitols or thousands of communities. Their Washington staffs are less than eager to let control of their favored activities get away from under their watchful eyes.

If the States received nonearmarked Federal funds they could substitute them for their own and slow down or discontinue their biennial rounds of tax boosts. They might apply the moneys to purposes other than those pursued by nationally organized special interest groups. They might not observe the innumerable conditions which professional interest groups usually succeed in writing into Federal statutes and regulations on programmatic grants. Last, but not least: States could not be threatened with the withholding of funds when Federal administrators are displeased with local practices.

The case for earmarked and conditional grants is not just that the States lack the capacity to finance the needed services—which argument has lost much of its force by the record of the postwar period—but that they won't do on their own initiative what needs to be done. If public services in the United States are being starved while consumers luxuriate, the blame lies largely with State and local governments. They did boost spending from their own sources in the past 20 years from $9.5 to $70 billion. But this, we are told, is far short of minimum requirements.

The population of the United States expanded 18 percent in the past 10 years and prices climbed 15 percent, while State and local expenditures for public services increased only 110 percent. That seemingly left a vast gap of unmet needs which had to be filled (at least partially) by a 240 percent growth in Federal grants to the States and a 175 percent increase in total Federal spending for domestic purposes. Personal income and consumption meanwhile grew 66 percent. In other words, governmental civilian spending increased about 2½ times faster than personal spending, a ratio which is widely held to be insufficient.

This seems to be a case of greyhounds chasing a mechanical hare. The hare of "public needs" will always be ahead of whatever government does, no matter how fast it multiplies its spending. If a public program fails to produce promised or hoped-for results that simply goes to prove that the appropriation was too small. Nothing is ever wrong with a government program that could not be corrected by doubling or tripling its amount. And since the National Government has shown a capacity and eagerness to boost its domestic outlays at a faster rate than State and local governments, major decisions on spending should be centralized at the national level.

The National Government was able to almost triple its domestic spending in the past 10 years (while its revenues grew only 60 percent) by bearing down on defense requirements. Outlays for national security increased only 13 percent which is less than the intervening

rise in prices. So, numerous major military programs and projects had to be scrapped, deferred or slowed down in order to provide more money for civilian purposes. In the battle for the budget dollar, the Armed Services almost always lost out to the politically Charmed Services—domestic welfare programs.

The groups committed to a faster growth of governmental services feel, not without reason, that to grant unconditional funds to the States would in the end mean a slower increase in total spending for the ends they mean to advance. So they keep pushing for programatic grants.

The cities have at best mixed feelings about the Heller plan. Not because they do not need or do not want the money. But they fear that without ironclad safeguards in the Federal statute State legislatures might not give them what they regard to be their fair share. Court-imposed reapportionment may lead to a strengthening of the suburbs more than of the central cities. So, mayors would rather put their hope in Congress to earmark funds for urban purposes. The two contenders who received the largest number of votes in last week's mayoralty election in New York City, based their promises and fiscal programs on almost identical demands for Federal grants to cities.

We all know that many of our major cities are in financial straits and are looking desperately for added revenue which they believe can come only from the National Government. Demands on city treasuries are skyrocketing while their tax base shrinks.

Some observers of the scene wonder why our big cities, the centers and very symbols of financial power, are in trouble. We are the world's richest nation and most of the country's wealth is of course not located in its open spaces but in the cities. Income, property and transactions are concentrated in New York, Chicago, Detroit, San Francisco, not on the farms. If our cities cannot make ends meet, what hope is there for Calcutta, Rio, or Hong Kong, or for smaller towns?

But the cities may have a good case: The citizens who can (and historically used to) provide their economic and tax base and civic leadership are leaving in droves. They are being replaced by residents who have little to offer in support, contributions or leadership but need and demand vastly expanded public services. What's more, the mass exodus of the middle and upper income groups from the cities is likely to increase in intensity in the years to come and multiply urban problems.

The flight from the cities is not necessarily a natural phenomenon like the weather or earthquakes. It is of coure due partly to rising affluence. But to a large extent it can be traced to perverse public policies. To be sure, city policies are not designed with the intent or for the purpose of driving out the higher and middle income families and attracting the poor—but they could not be much different if they were. Some of those policies are the result of Federal influence or demands. But many are city-made. And as time goes on and voter composition changes, the heads of city governments can less and less politically afford to resist the pressure of the new masses for a course of action which will shrink their tax base further. We may have passed the point of no return. And as cities become increasingly dependent on outside support they clamor for earmarked Federal grants, not tax rebates.

Proponents of general grants to the States draw comfort from the fact that the idea was advanced by liberals but has drawn much support from conservatives including the Republican candidate in the last presidential election. This, they feel, proves that the plan has merits regardless of ideological leanings or political affiliation. They tend to overlook a crucial distinction: liberals who favor general grants want them in addition to specific or programmatic grants (which should keep expanding) while conservatives who suport the plan mean general grants to replace specific and conditional grants.

Conservatives are attracted by general grants or tax sharing—in lieu of programatic grants—because they would help shift decisions over domestic public services back to states and communities and reestablish local autonomy. Moreover such a change would enable the President and Congress who are now preoccupied with domestic affairs free to devote most of their time and attention to the consideration of national security and foreign relations. Our unsatisfactory position in world affairs and the decline of American power as well as prestige and influence abroad may well be related to the little time given to their study by the leaders of our Federal Government. Concentration on national security and international affairs by the President and Congress would not necessarily bring about decisions of greater wisdom but at least make for decisions arrived at with greater knowledge and care.

Liberal support for general grants is based on an entirely different rationale, on a prediction that a surplus will develop in the federal budget which might exert a "fiscal drag" on the economy. Just how realistic that expectation is remains to be seen. Budgetary deficits in the past 5 years totaled $28 billion and the built-in increases of old and newly enacted and expanded programs (plus hoped-for-further tax relief and future new spending programs) do not suggest the likelihood that the budget will be anywhere near a balance for as far as we can see ahead.

FEDERAL GRANTS AND FEDERAL CONTROL

Ten years ago, at the National Tax Conference in Detroit, the chairman of this panel, Prof. Alfred Buchler, remarked that "the real question may not be one of assuring the States adequate revenues but of maintaining Federal supervision over State activity through grants-in-aid." This was certainly borne out in subsequent years when statutes and administrative practices steadily tightened.

When the U.S. Government grants aid to foreign govenments it often refrains from watching the spending too closely for fear of offending sensitive feelings. It also forbids the States to direct or influence welfare recipients on how they ought to spend their monthly benefits. But our State governments can apparently neither be trusted to expend U.S. funds with as much wisdom as foreign governments or public assistance recipients nor need they be treated with as much restraint or delicacy.

Until not so many years ago the drive for Federal funds for education and other services advanced under the motto "Federal aid without Federal control." Since then Federal money for schools and col-

leges has multiplied to several billions of dollars annually but no program of general support for operations which the schools and colleges demanded was ever authorized—or has much chance of enactment. Dozens of programs are being piled on top of each other for individual projects or specified small segments of school and college operations, each with detailed conditions and controls. In a symposium volume published earlier this year Seymour Harris pondered: "A puzzling aspect of educational history is the success with specific programs and the failure to obtain general aid."

That aspect need no longer be puzzling. It is now obvious—and some of us stated so years ago—that the battle over Federal aid to education was fought not so much over money but over power. Congress now determines which subjects in education are to be advanced and how. Since this still leaves much leeway, recent aid statutes require each university or State department or school district that wishes to get Federal money to prepare an individual application to the U.S. Commissioner of Education, setting forth in great detail how those funds—and their own funds—are to be spent. This gives the commissioner all power necessary to rule the educational system, by granting or denying the money.

He may occasionally overstep his bounds—as he did a few weeks ago when he threatened to withhold funds from the Chicago schools, seemingly oblivious of the direct line which the present mayor of Chicago maintains to the White House. Mayor Daley was able to get the order quickly rescinded and the Commissioner's ears pinned back. But how many of the country's 26,000 school districts are in as fortunate a position as the Mayor of Chicago?

You know how jealous universities and colleges are of their academic freedom and autonomy, how they guard against intrusions by State officials or anybody else. In some States such as California, Michigan, etc., the autonomy of the university is constitutional and legislative appropriations for operations are made in a one line item to be spent at the discretion of the institution. But Federal funds are parceled out in dribs for highly selected purposes and with minute specifications and controls.

It has now become too plain to require much proof or be subject to argument that the basic purpose of functional grants-in-aid is the transfer of control over domestic public services from State and local governments to Federal authorities. One of the leaders in the movement for Federal aid to education, Representative Frank Thompson, of New Jersey, said recently:

> I am no more afraid of the judgment of the Federal Government in the field of education—I am less afraid of it than I am of the judgment of some of the locally elected school boards with respect to the administration of education programs.

With the multiplication of specific grant programs it is becoming evident that the United States is in the midst of a process of changing from a federal system of government to a unitary or centralized system in which all major public activities are determined and controlled at the national level. There is a direct Federal-State-local chain of command through a functionally organized bureaucracy in most domestic services. Some years ago we were told that a functional divi-

sion among levels of government was outmoded and that we no longer had a "layer cake" government but a "marble cake" government. By now we have, as Joseph McLean so well called it a "vertical functional autocracy," an integration of major public services from Washington to every small town. And the means by which the disintegration of "horizontal" government was and is being accomplished is the functional grant-in-aid.

This is why no program of general aid to the States was ever adopted or is likely to be authorized. The number of grants has multiplied and a catalog prepared for the Senate Subcommittee on Intergovernmental Relations in April 1964 counted 216 separate program authorizations, a supplement in January 1965 listed over 30 more and the first session of the 89th Congress which adjourned 2 weeks ago added a few dozen new ones. Remaining gaps—of State and local activities not yet under a Federal program—are being rapidly closed. There is much duplication and overlapping of programs with similar objectives or clientele, particularly in education, welfare and the poverty drive, with several Washington and local bureaus seemingly engaged in fierce campaigns of violent noncoordination. The number of intricacy of grant programs has now reached a point where a continued multiplication will lead to increasing friction, confusion and eventual chaos.

To be sure, thought has been given on how to create order out of confusion in studies by the Senate and House Committees on Intergovernmental Relations and particularly by the Advisory Commission on Intergovernmental Relations. That commission, created in 1959, was not intended to stem the flow of governmental centralization as was its predecessor, the (first) Commission on Intergovernmental Relations. Its task is more limited and pragmatic—to help take the rough spots, the creaks and friction points out of Federal-State-local relations and to aid smoother cooperation.

The commission's staff has produced a series of solid research reports but the commission has continued its predecessor's tradition of anonymity, if not by it own volition. A recent survey revealed that less than one-sixth of over 900 top-level State executives had ever heard of the commission and an article by Deil S. Wright in the September 1965 issue of the Public Administration Review disclosed that no direct references to the commission appeared in the annual indexes of the pertinent major professional journals, that no cabinet-level appointee has attended any of the quarterly meetings of the commission since the organization meetings late in 1959 and early 1960, and that no President ever turned to the commission for recommendations on matters of policy.

No More "Intergovernmental" Relations?

Its low rank in the councils of government is no fault of the commission. Rather it springs from the fact that intergovernmental considerations are no longer relevant to Federal policy decisions on domestic programs. They are only the technical means by which decisions to initiate, expand or alter public services are being carried out. Programatic Federal grants are devices to establish new or modify old governmental activities which are constitutionally, and have tradi-

tionally been regarded to be, in the realm of the States. They do not aid the States, they use the States to carry out commands of the Federal Government. This reminds me of the story of the two boy scouts who came late to the troop meeting and when asked for an explanation said: "We helped an old lady to cross the street." "Did that take you a whole hour?" their leader inquired. "Yes, it did," they replied, "she did not want to go."

Besides offering certain conveniences, grants are also the cheapest way for the Federal Government to implement its decisions on domestic public services. Through a contribution which sometimes exceeds 75 percent but more often equals one-half, one-third or less of the cost, the central authorities acquire as definite a control as if they bore the full cost: they establish the condition under which funds are made available and no State can afford to forego its allotment to which its residents must contribute a share through their Federal taxes.

In Canada intergovernmental payments and tax allocations are negotiated and settled at periodic meetings of the Dominion Prime Minister with the provincial premiers because they are regarded to be matters between the Dominion and the provinces. In the United States general State authorities—governors, budget officers, legislatures—are not part of the process that leads to new or expanded Federal grant programs. Federal grants, usually recommended by the President, are a matter between the pertinent Federal cabinet department, the functional committees of Congress and the affected nationally organized interest groups.

State or local officials called in for consultation are the administrators of a particular program, never general State officials. Decisions by Congress, and later by the Federal bureaus, are decisions on the substance of education, public welfare, roads or urban affairs in which the State legislatures have little choice. Pending proposals would further restrict the limited discretion State legislatures still enjoy. The protagonists of governmental centralization have "wisely refrained from tampering with the Ark of the Covenant" as Rowland Egger so well phrased it. The symbols have been preserved and the rituals carefully respected. Lip service to local autonomy and home rule is as lavish as ever. But the substance of authority has passed into the hands of the National Government. The formality or facade of Federal grants is only used in order to maintain the fiction that we still have a federal system of government.

At the General Assembly of the States in December 1948 Roscoe Drummond said, "The issue has been foreclosed by events. The federal system no longer exists. The trend toward centralized Federal Government is overwhelming, inevitable, irreversible, and to a degree, irresponsible. It is a part of American life." He added that the federal system can no more be restored than an apple pie can be put back on the apple tree. Some State officials felt at the time like replying with Mark Twain's famous telegram to a newspaper, "Notice of my death greatly exaggerated." But Mr. Drummond was at most slightly premature. In July 1965, David Brinkley, speaking to the assembled students of the University of Ohio said:

> The decline and fall of the 50 State governments will be completed within our lifetime. The movement of political power from

state capitals to Washington is inevitable and unstoppable whether we like it or not.

Mr. Brinkley, it seems, likes the trend while others may not. But his judgment of what is happening in our system of government, in my opinion, can hardly be questioned.

As the number of Federal grants soars, from 100 a few years back to over 250 at the present time, and possibly 300 or 400 some years hence—considering innumerable proposals to fill remaining "gaps"—the system is turning so cumbersome as to become completely unworkable. A basic change is called for to prevent utter chaos.

What purpose is served by maintaining the fiction of a State program aided by the National Government when the latter provides 100 or 90 or 75 to 80 percent of the cost as it does in unemployment administration, on interstate highways and in some segments of public welfare and education? As trends go, the National Government will in all likelihood eventually take over many or most of those services as the complications of maintaining the pretense of "intergovernmental cooperation" become unbearable, too obviously wasteful and useless.

Why should the issue of the governance of public services not now be placed squarely on the table and before the American people? To pile dozen or hundreds of new "grants-in-aid" to States on over 250 current ones serves no purpose other than to confuse the public and make governmental authority and responsibility incomprehensible.

To be sure: I am not proposing that the National Government now take over all or some of the various public services which are now provided in the name of State and local governments under Federal direction and with Federal financing. But I wonder whether we should continue to drift into the "end loesung" (final solution) or face the issue now of what kind of government Americans want to have: centralized power and chain-of-command or home rule. Grants-in-aid which were the lever of change may be as good a place as any to consider the alternative that faces us.

GOVERNMENT FOR TOMORROW: A PROPOSAL FOR THE UNCONDITIONAL SHARING OF FEDERAL TAX REVENUES WITH STATE AND LOCAL GOVERNMENTS*

BY THE REPUBLICAN GOVERNORS' ASSOCIATION AND THE RIPON SOCIETY

FOREWORD

The Republican Governors' Association is delighted to have a major part in the task of preparing this paper. The association believes that the proposals incorporated in this research paper open exciting new vistas for accomplishment in intergovernmental relationships. We stand ready to cooperate with the States, with the President, and with the Congress in working out a detailed plan for the accomplishment of this salutary objective.

The proposal to share Federal tax revenues with the States is the first really workable suggestion for correcting a developing imbalance in the revenue structure of government at all levels to be advanced in many years.

Since the final draft of the paper was agreed to, the Western Governors' conference has unanimously approved the proposal for unconditional sharing of Federal tax revenues with the States. This wide bipartisan base of support insures sympathetic consideration by the National Governors' conference. On June 8, 1965, the Illinois State Senate approved Senate Resolution No. 22 which added the support of that body to this proposal. Several other legislatures have endorsed the proposal.

The once friendly attitude of the President would seem to indicate that the proposal to share might yet be considered in an affirmative frame of reference in the executive establishment of the Federal Government.

The Republican Governors' Association desires to express its appreciation for the assistance of Dr. Carl McMurray of the association staff in the preparation of this paper and for the cooperation of the Ripon Society.

It is our hope that this will be the first of a series of productive papers on State government problems and on the problem of relationships between the States and the Federal Government. The preservation of our uniquely excellent Federal system is important. Increasing emphasis on the important role of State government in that system will tend to strengthen the entire structure of government in its efforts to serve all of our people. Strong and effective State and local govern-

*A research paper issued jointly by the Republican Governors' Association and the Ripon Society, July 1965.

ments are the surest defense against the Democratic drive toward increased centralism in Washington.

ROBERT E. SMYLIE,
Chairman, Republican Governors' Association.

BOISE, IDAHO, *July 6, 1965.*

FOREWORD

We of the Ripon Society firmly believe that the Republican Governors and the new generation of Republican leaders in the States represent the real hope for the future of a new Republican Party. We believe that strengthening State and local governments will be one of the great challenges of a new and exciting era in our political history. And one of the first problem areas where Republicans must provide creative leadership is in finding adequate tax revenues for expanding State and local services.

For these reasons we are happy to have worked with the Republican Governors' Association and its staff in the preparation and circulation of this research paper. It is our sincere hope that this paper will promote discussion and interest in one of the few really new major policy ideas that has been advanced in recent years. Both Republicans and Democrats have had a part in its inception. We now ask the President to welcome the efforts of the Nation's Governors—of both political parties—and to commit the full prestige, resources, and leadership of his office toward the achievement of a workable revenue-sharing program with the States. We feel that this study presents persuasive arguments for such a program.

As young Americans vitally concerned with the future strength of our governments—Federal, State, and local—we ask for a vision which sees beyond the years. The poet has said that boldness has genius, power, and magic in it. Now is a time for such boldness. We dare to believe that we can find practical solutions to the problems of our Federal system, that we can build government for tomorrow.

JOHN S. SALOMA III, *President*
The Ripon Society

WASHINGTON, D.C., *July 6, 1965.*

The Ripon Society wishes to thank Mr. Lee Heubner, member of the Ripon Executive Board and a graduate student in history at Harvard University, for his work in heading the Ripon research task force that prepared the working draft of this study. The society extends its appreciation to the Republican Governors' Association for its sponsorship of the research paper, and to Dr. Carl McMurray, of the association staff and Mr. Robert McCall, assistant to Gov. Robert Smylie, for their assistance in preparing the final draft.

GOVERNMENT FOR TOMORROW

For a while it seemed as though everyone was for it. President Johnson and Senator Goldwater endorsed the idea in the closing days of the 1964 campaign. Both the Republican and Democratic platforms gave it favorable notice during the summer. The Conference of State Governors supported it enthusiastically.

Liberal economists and conservative Congressmen joined editorial writers and columnists of all persuasions in backing the proposal. The most popular version of the idea bore the name of the President's chief economic adviser, Dr. Walter Heller. A special Presidential task force, headed by Dr. Joseph Pechman of the Brookings Institution, gave formal approval after a detailed study.

The object of all this affection was the so-called Heller proposal to distribute some Federal income tax revenue to State governments on a "no strings" basis. Economist Robert Heilbroner described the plan as "that rarest of rarities—a really new idea in domestic economic policy." Edwin Dale, economics specialist for the New York Times wrote in the New Republic that it was "one of the most exciting ideas to hit Washington in years." Heller, then Chairman of the President's Council of Economic Advisers, began to publicize the idea in this country early in 1964. Republicans welcomed a plan which expressed the concern for State government which President Eisenhower and other leaders had urged for so many years. Support grew quickly and by December one editorial writer predicted that "it would seem to have at least a decent chance of winning congressional approval." [1]

But the prediction was never tested. For in mid-December the President did a bristling about-face. He was irritated, he told reporters at a background conference, because the favorable recommendations of the Pechman task force had been leaked to certain newspapers. He was annoyed because the leak had generated criticism. Angrily, and without any reference to its merits, he shelved the proposal—its widespread support notwithstanding.

But it did not stay shelved. Journalists reminded the President of his campaign promises. "It deserved a better fate," the New York Times lamented, "at least a thorough airing." Economists continued to plug for it. " * * * [I]t seems a good bet that sooner or later someone will discover its merits," wrote Heilbroner. Later in March, the Nation's Governors prodded the President one more time. Republican Gov. Robert Smylie of Idaho announced that the Governors had asked the President to permit a new study of the Heller plan. They were told that the idea was under review in the Bureau of Budget. There it languishes today.[2]

For reasons which are developed in this paper, the Republican Governors' Association and Ripon Society support the revenue-sharing proposal. We believe that the idea should be judged on its merits and not removed from the realm of public discussion because of personal peevishness on the part of the President. It is our hope that President Johnson will rise above his pique and permit the resources of the Executive Office and the Pechman task force, in full cooperation with the Nation's Governors, to begin fashioning a workable legislative proposal for revenue distribution to the States.

Government for Tomorrow: Opportunity and Crisis

We live in an era when events threaten to outrace our ability to respond to them. Too much of present-day politics is caught up in

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[1] Robert Heilbroner, "The Share-the-Tax-Revenue Plan," *New York Times Magazine*, Dec. 27, 1964, p. 8; Edwin L. Dale, Jr. "Subsidizing the States," the *New Republic*, Nov. 28, 1964, p. 11; *Commonweal*, Dec. 25, 1964, p. 437.

[2] *New York Times*, Dec. 21, 1964, p. 28; Heilbroner, *New York Times Magazine*, p. 31; *New York Times*, Mar. 23, 1965, pp. 14 and 16.

the rhetoric of the 1930's while the accelerated pulse of life requires that we develop dramatic new solutions to the problems of today and those of the 1970's and 1980's. The United States is entering upon a period of political turbulence, in which a new and much younger population will confront issues which are different in kind and in scope from those of the past generation. They are the sort of problems which convince us that the exciting new area of political action, the great new opportunity for boldness and creativity and innovation, will be found more and more at the State and local level.

Consider the most dramatic challenges.

> [T]he focus of domestic politics, Peter Drucker has written recently, "is likely to shift to two new areas: the metropolis and the school." The cities, he argues "are rapidly becoming unlivable * * *. But long before we can hope to come to grips with the city as a human environment we will have to come to grips with the city as a government. And the need is desperate. Within a few years three-quarters of the American people will live in a fairly small number of metropolitan areas, fewer than 200.

As for education:

> Five to eight years from now, around 50 percent more students should be in American colleges than there are today * * *. Altogether our society will be school centered * * *. At least one-third of the American people will be in school a few years hence * * *. Teachers are already the largest single occupational group in the country.[3]

Exploding population, rapid urbanization, higher prices and advanced technology are placing enormous pressures on State and local governments. The country is growing by some 8,000 persons every day and as Life magazine said in an editorial last December, "The States have had to bear the full brunt of the population explosion."[4] In fact, vast new sums are necessary if even the most ordinary, ongoing functions are to be adequately maintained. Programs such as education, fire and police protection, streets and highways, health and sanitation, recreation, welfare, water, and transportation must not be cut back. Nor can we safely allow control of such concerns to slip further into Federal hands.

The States and localities do not want to curtail or surrender these responsibilities. That is why they have increased their budgets to twice the level of Federal domestic expenditures. That is why they have doubled their employment over the past 13 years so that it is now three times that of the Federal civilian level. And yet, the States and localities face a crisis. For at a moment when the future is rushing in upon them with such remarkable speed, they are victims of a financial resource base which is decades out of date.

All too often headlines announce that the States must "Live on Crumbs": that they are "Frantic for Cash."[5] The pressure of rising costs distorts the whole pattern of State and local performance. Offi-

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[3] Peter F. Drucker, "American Directions: a Forecast," *Harper's*, February 1965, pp. 40–42.

[4] *Life*, Dec. 18, 1964, p. 4.

[5] John Anderson, "Can the States Live on Crumbs," *Saturday Review*, Jan. 9, 1965, p. 31; *U.S. News & World Report*, Sept. 17, 1964, pp. 79–80. Former Governor Anderson's remarks were originally given before the Committee for Economic Development, Washington, D.C., Nov. 19, 1964.

cials are constantly preoccupied with fiscal crises. Mayors and Governors are repeatedly evaluated by their ability to wriggle out of one financial squeeze after another. A vicious circle is promoted which produces low esteem for State and local capacities. Ironically, this loss of prestige is occuring during a period when State leaders have shown a remarkable willingness to undertake new responsibilities. Problems result not from lack of will but from lack of money. The effect, as Governor Rockefeller has said, is that, "Our Federal system—and the basic concept of responsive government close to the people—is threatened as never before." [6]

THE VIRTUES OF STATE AND LOCAL GOVERNMENT

We dare not let this threat continue. For vigorous government at the State and local levels has several indispensable values.

1. A decision is made more rationally when those who make it must live directly with its consequences. As Prof. Otto Eckstein of the Council of Economic Advisers phrases it, there is "a greater coincidence between the distribution of benefits and costs." [7]
2. A multiplicity of State and local governments creates the possibility of a choice by citizens and forces each government to face the test of comparison with others.
3. Decentralized government permits a variety of values, protecting legitimate minority and regional interests. A widely diversified people need not submit to a single pattern of public life.
4. Innovation and experimentation are fostered by small-scale government. What works well in one setting can spread from State to State as many new ideas did early in the 19th century and during the progressive era.
5. Healthy State and local government increases citizen participation and reduces the sense of political alienation.
6. State and local governments can provide a source of strength for the party which is out of power at the national level and thus contribute to meaningful two-party politics.
7. Social and economic complexities can often be most easily untangled by State and local units. We repudiate the myth that an increasingly complex society always requires increasingly centralized government. Sometimes new domestic problems call for solutions which can be developed most effectively at the national level. But, the administration of the solutions to these problems can often be managed most efficiently on the local level. We reaffirm our belief that modern society requires flexible, pluralistic government.

Let us admit that we are speaking without apology in defense of a Federal system; we are not speaking against the Federal Government. We believe that we cannot seize the future unless the various orders of government become allies rather than enemies. As former President Eisenhower said last June, "The better the States do their jobs, the better the chance that the Federal Government will cooperate properly

[6] Gov. Nelson A. Rockefeller, remarks prepared for delivery at luncheon, City Club of Portland, Portland, Oreg.; Apr. 17, 1964. Unpublished press release.
[7] Otto Eckstein, *Public Finance* (Englewood Cliffs, N.J., 1964), p. 34.

and effectively with them. * * *"[8] To do this "better job" the States need new sources of revenue.

Rising Costs

Let us consider the way in which the bills have been piling up. Eighteen years is not a long time, yet State and local expenditures in 1964 were six times greater than they were in 1946. State and local outlays for education alone increased from $3 billion at the end of World War II to $22 billion last year. In 1964 State and local governments spent a total of $65 billion—twice as much as the Federal Government spent on domestic program. Over the past 10 years, State and local expenditures have risen at 8 percent a year—twice as fast as gross national product. Let no one say that States have not moved to meet increased demands.[9]

But the dizzying pace is just beginning. This spring State Governors requested budget increases totaling $5.44 billion over the previous biennium. The Council of State Governments has recently estimated that the States must raise $2 billion by 1970 in addition to what is now in sight—solely for higher education. Total educational outlays are expected to more than double in the next 7 years. Health and sanitation costs will increase 2½ times, housing and community developments expenses will be 10 times the present level. Economists estimate that State and local governments, which spent $65 billion last year, will be spending $82 billion by 1967, $100 to $120 billion by 1970, and as much as $155 billion just 9 years from now in 1974. By that time they will have far outstripped Federal expenditures for domestic, military, and foreign policy purposes combined.[10]

But the sad fact is that present financial resources are not abundant enough to meet these needs. Nor do they show promise for sufficient expansion in the future. Indeed, almost every imaginable tax resource has already been subjected increasing and often undesirable pressures. State taxes alone have gone from $4.9 billion in 1946 to $24.2 billion in 1964, an average increase of over a billion dollars a year. A sharp jump in 1963 produced a hike in property taxes of 7.3 percent over the previous year; sales taxes went up 8.7 percent, corporate and individual income taxes rose 7.5 and 6.3 percent respectively—all in 1 year. In 1964, State tax increases siphoned off one-third of the $6.5 billion Federal tax cut. Despite warnings from economists, a bewildering variety of consumption, payroll, and service taxes have appeared at the local level from Detroit to Oakland, Fairbanks to Mobile, Los Angeles to Baltimore. Over 40 cities have recently imposed motel

[8] Former President Dwight D. Eisenhower, address to 56th Governors' conference, reported in the New York Times, June 9, 1964, p. 24. General Eisenhower went on to say: "Our best protection against bigger government in Washington is better government in the States * * *. Time and again over the earlier years of my administration, I had met with State Governors, singly and in groups. Invariably we agreed on the theory of returning more power, more responsibility more tax revenue to the States. In practice, however, difficulties—sometimes apparently insuperable—always presented themselves."

[9] These statistics are drawn from three of the best recent articles on the Heller proposal by Heilbroner, Dale, and Anderson—cited above. See also the very excellent report of Alan L. Otten and Charle B. Seib, "No-String Aid for the States?", *Reporter,* Jan. 28, 1965, pp. 33–35.

[10] An excellent report on current State expenditures and budget requests is a two-part series by Edgar M. Mills, "State Living Costs Rise, Too," *Christian Science Monitor*, Apr. 8, 1965, pp. 1 and 4 and Apr. 10, 1965, p. 11; *New York Times*, Apr. 11, 1965, p. 29; Rockefeller Portland Speech—cited above.

and hotel taxes in an effort to shift their burdens to nonresidents. In a frantic search for additional revenues, New Hampshire has instituted a sweepstakes.[11]

The end is not in sight. Twenty-six Governors have asked for tax increases this past spring and many of those who are relying on larger yields from present taxes have warned their legislatures that tax hikes are a future necessity.[12] Yet there is evidence that traditional taxes have already reached the limits of desirable expansion. Let us examime more closely the current status of the income tax, the property tax and the sales tax.

The Limits of Current Tax Sources

Of all revenues, only the income tax expands quickly with the growing economy. Yet only 12 percent of State and local moneys are drawn from this source. Governors in nine States are presently seeking income tax revisions to produce much heavier yields.[13] While we applaud their courage, we emphasize that State income taxes cannot solve the problems. The distinguished economist, John Due, explains why in his noted textbook, "Government Finance":

> The possibility of migration of the tax base is the economic consideration of primary importance. Whenever migration is relatively easy, attempts to tax will yield little revenue and will produce economic effects particularly adverse to the tax jurisdiction. * * * Heavy State taxation of income may induce some persons to leave the State. * * * Income taxes can, without question, be administered most effectively and with least migration of economic activity by the Federal Government.[14]

Professor Due goes on to point out that on the State level actual migration is not as great a problem as is the threat of migration on political leaders. Cutthroat competition for industry and labor makes it extremely difficult to raise income taxes at the State level. In Oregon 2 years ago, the voters refused an income tax which was strongly supported by education leaders, labor officials, both houses of the legislature, and the Governor. New Jersey, Michigan, South Dakota, and Vermont all refused to approve income tax revisions last year. Several States have constitutional limitations on nonproperty taxes.[15]

Even if income taxes could be increased, interjurisdictional and other administrative problems make this an inefficient levy. Evasion on the one hand and double taxation on the other create serious problems. State income tax machinery duplicates that of the Federal Government, needlessly and inefficiently. Moreover, when State increases are added to Federal income taxes, the overall tax structure can become illogical and excessive for some taxpayers.

The property tax is more appropriate for State-local use but economists generally agree that it has been overused and cannot be raised much higher. It presently accounts for 45 percent of State and local

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[11] See note 9. Also *U.S. News & World Report,* Apr. 20, 1964, p. —, Sept. 14, 1964, pp. 79–80; and Nov. 30, 1964, pp. 95–96.

[12] Mills, *Christian Science Monitor,* Apr. 8, 1965, pp. 1 and 4.

[13] Anderson, *Saturday Review,* p. 32; Mills, *Christian Science Monitor,* Apr. 10, 1965, p. 11.

[14] John F. Due, *Government Finance, an Economic Analysis* (Homewood, Ill., 1959), p. 68. Much of our analysis of current tax mechanisms is drawn from Professor Due's discussion.

[15] *U.S. News & World Report,* Oct. 28, 1963, pp. 102–104; and Nov. 30, 1964, pp. 95–96.

income.[16] Property taxes are often inequitable in that they apply to only one kind of wealth. Vast nonproperty resources can escape taxation while the unfortunate property owner cannot even obtain an adjustment for debt outstanding against his proprty. An unjust and painful burden falls on homeowners with small current incomes—retired persons and widows are particularly hard hit and often lack cash to pay taxes on homes they bought years before. The property tax can also be highly regressive; it is tied to housing expenditures which are typically regressive relative to income.

Many State and local governmental units are presently looking to the sales tax to get them out of fiscal trouble. Thirty-seven States now have sales taxes. In three more (New York, Massachusetts, and Idaho) Governors asked their legislatures to add such levies this year. In 10 States, Governors requested sales tax increases and extensions in 1965. Selective levies are also popular. For example, 12 States this year considered increases in cigarette taxes—from 3 cents to 8 cents a pack in California, 5 cents to 10 cents in New York, 4 cents to 8 cents in Illinois and so on. Gasoline taxes run very high. Thirteen States allow further city sales taxes and these too have climbed.[17]

Again, consumption taxes in many areas have gone about as high as they can go. Some States have constitutional barriers and in all States 5 percent is seen as the upper reasonable limit. Moreover, the sales tax is a regressive instrument and tolerable only when it is a relatively small part of an overall progressive structure. It favors those who can save; it places a burden on large families. It can produce pressure for inflationary wage increases, but more often it discourages consumption and investment and thus has a deflationary effect. Selective taxes can change buying patterns when they get too high. Local taxes can drive consumers to the suburbs. Sales taxes are useful within limits but the limits are rapidly being approached.

Consequence of the Squeeze

The sad truth of State and local finance is that costs are rising faster than revenues. The consequences of this squeeze are evident on every hand.

Dramatic evidence of the growing disparity between government responsibilities and government resources is found in the enormous increase in State and local debt. From a $15.9 billion level in 1946, public indebtedness at the State and local level had almost doubled by 1952 when it reached $30 billion. In the thirteen years since then, State and local debt has tripled, an average increase of more than $4½ billion per year. Approximately $90 billion is outstanding today.[18]

Fiscal problems have also created political blight. Former Republican Gov. John Anderson, of Kansas, recently described the problem before the Committee for Economic Development:

The rate of "tax mortality" among State and local political leaders is very high. A Governor or mayor must raise taxes in order to meet his increasing responsibilities but he is often voted out of office for

[16] Anderson, *Saturday Review*, p. 32.
[17] Mills, *Christian Science Monitor*, Apr. 10, 1965, p. 11.
[18] Heilbroner, *New York Times Magazine*, p. 8; Otten and Seib, *Reporter*, p. 34.

doing so. Were he to choose to cut services rather than to raise taxes, he would also be likely to get kicked out.[19]

"Tax mortality" was evident in the last off-year elections in 1962 when 13 incumbent Governors were ousted. Tax policy was a major issue in every State election in 1962 and 1964, and it is already apparent that taxation will again be a major issue in the 38 gubernatorial races in 1966.

Unfortunately impoverished State governments have sometimes been forced to abandon or limit needed programs. More often, however, they have managed to raise taxes, increase debt, or—what is perhaps most significant—look to Washington, D.C., for help.

Federal Aid Fills the Gap

The Federal Government has been ready to fill the gap. In just the last 11 years, Federal aid to the States has almost quadrupled. It stood at $2.7 billion in 1954; it amounts to approximately $11 billion this year, about 15 percent of State and local general revenues. In his 1964 text, American Intergovernmental Relations, W. Brooke Graves discusses the immense problems he had in trying to just compile a list of all Federal grant programs. His roster stretches for 22 pages; two-thirds of the entries have been added since 1930. The need for many of these programs has long since disappeared, Professor Graves argues, yet specific grants do not diminish; they multiply.[20]

Last year's Republican platform pledged "critical reexamination and major overhaul of all Federal grant-in-aid programs." In 1961, the highly respected Advisory Commission on Intergovernmental Relations became so alarmed about entrenched and useless programs that it recommended that each grant program be automatically terminated 5 years after its establishment unless specifically continued at that time. The Commission, a bipartisan body which includes Cabinet officers, Congressmen, and local officials, has recognized that "there is nothing so permanent as a temporary grant-in-aid." "It becomes a going concern," writes political scientist William G. Carleton. "[V]ested interests are created, the controversial becomes customary, and the opposition vanishes." [21]

Almost all informed observers agree that the thick underbrush of Federal grant programs wastes money on outdated operations while real needs are unmet. What is even more reprehensible is that the States are forced to reproduce Federal errors and to match Federal blunders. Present "conditional" grants-in-aid give Washington important controls over State and local budgeting. Public officials find it difficult to turn down Federal money. Yet the requirement that States match Federal funds forces them to forego other activities which are often more important. Many Governors have spoken ruefully of "those armories we really didn't need," yet built because "we could get them relatively cheaply." The Reporter magazine has pointed out that "poor States in particular feel obliged to put a disproportionate share of

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[19] Anderson, *Saturday Review*, p. 31.

[20] *Business Week*, Sept. 19, 1964, p. 112; Anderson, *Saturday Review*, p. 31; W. Brooke Graves, *American Intergovernmental Relations* (New York, 1964), pp. 569–571, 932–954.

[21] "For the People," Republican platform, 1964; Graves, *American Intergovernmental Relations*, pp. 811–812; Anderson, *Saturday Review*, p. 32; William G. Carleton, "Centralization and the Open Society," *Political Science Quarterly*, June 1960, pp. 244–259.

their funds into federally matched programs such as highways and airports, rather than into such unaided programs as fire and police protection." The result, writes Professor Due, is that "the overall budget may be substantially different from that which would most satisfactorily meet the desires of the community." He warns of "a precedent for possible drastic interference with the functions of the States." [22]

Furthermore, as the fiscal squeeze tightens, States and localities are tied financially to these outdated programs and they are unable to find matching funds for the more important new Federal grants. For this reason job retraining programs will be endangered when a matching requirement becomes effective this summer. When the executive committee of the Governors conference endorsed the Heller plan last year, this was one of its most telling arguments.[23]

Conditional grants also involve severe administrative problems. Former President Eisenhower has described "the cloying effects of Federal subsidies which invariably are accompanied by an overbearing Federal bureaucracy * * *." Facts and testimony support his description. Direct overhead costs alone are pegged at 16 percent. State officials must frequently wrangle with Federal bureaucrats over the substance of essentially local programs, and they almost always lose to the pressure from the purse. No matter how clearly the language of the law appears to support their position, it is virtually impossible for States to obtain judicial review of such administrative actions. Michigan, Oregon, and South Dakota have experienced recent frustrations of this sort. Intricate and petty Federal rules have come under increasing fire. Just last November, the Advisory Commission in Intergovernmental Relations warned of "points of friction in Federal-State relations in the administration of public assistance." Pointing to examples of self-defeating regulations and needless red tape, the Commission recommended that Federal controls be "kept to a minimum." Governor Anderson summarizes well our whole discussion of present grants-in-aid when says, "We are approaching the limits of manageability in the variety and complexity of Federal grant programs * * *. Many thoughtful people are coming to the conclusion that there must be simpler and better ways of making future Federal funds available to the States." [24]

A Better Answer

What can be done to ease the fiscal crisis in States and localities? Taxes can be reformed and adjusted, credit can be strengthened and extended. Federal aids can be reviewed and streamlined. But none of these options can give more than limited relief. Without more dramatic help it is likely that State functions will continue to slip away under the enormous pressures of the next two decades.

But our search for a "simpler and better way" is not without hope. For in dramatic contrast to the bleak fiscal picture at the local and State level, the Federal Government today faces the prospect of in-

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[22] Otten and Seib, *The Reporter*, p. 35; Due, *Government and Finance*, p. 479.

[23] Otten and Seib, *The Reporter*, p. 35.

[24] Dwight D. Eisenhower, "Why I Am a Republican," *Saturday Evening Post*, Apr. 11, 1964, p. 17; *Wall Street Journal*, Nov. 17, 1964, p. 12; Anderson, *Saturday Review*, p. 32.

creasing revenues. Because the Federal tax structure is highly responsive to economic growth, prosperity generates ever-increasing tax returns. There is expectation that these revenues will soon begin to exceed expenditures. Unless this margin is returned to the economy, observers fear it will act as an automatic "brake" on national growth. Walter Heller (along with James M. Tobin and Budget Director Kermit Gordon) began to sound an alarm about "fiscal drag" soon after he arrived in Washington in 1961. (He had spoken of it even before the 1960 election.) His concern helped to bring about last year's tax cut, but even that did not sufficiently limit "the Federal suction machine." In 1964 Heller pointed to a $6 billion annual increase in Federal tax revenue and suggested that a part of it be funneled back into the economy through unrestricted grants to the States. This procedure would serve the dual purpose of stimulating the economy across the whole range of 50 States and, consequently, pump funds into the existing sources of State revenues.[25]

The ironic truth of the matter is that where the needs are greatest, current revenue is smallest. The States and localities bear the brunt of the population boom, but the Federal Government reaps the fruits of the new prosperity. State revenues are embarrassingly small; Federal revenues are embarrassingly large. This condition is a direct result of the fact that most revenues can be collected with the highest degree of effectiveness by the Federal Government. It produces massive Federal intrusion into essentially local concerns, the values of local planning and administration notwithstanding.

It is our belief that this logic is not inevitable. We dare to believe that we can have the best of both worlds—the efficiencies of centralized taxation and the advantages of decentralized expenditure. By using existing State facilities for the allocation of these funds to a variety of public services we would also curtail the monumental growth of the Federal bureaucracy with its duplication of services and conflicting jurisdictions. More money would go into services and less into bureaucratic overhead. It is for these reasons that we urge the adoption of a revenue-sharing proposal such as the Heller plan.

The Sharing of Tax Revenues—Some Details

It was just 6 days before the presidential election that the White House issued the following description of a revenue-sharing program.

> In line with the Democratic platform this administration is moving ahead on development of fiscal policies which would provide revenue sources to hard-pressed State and local government sources to assist them with their responsibilities.
>
> At the State and local level we see responsibilities rising faster than revenues, while at the Federal level an average annual revenue growth of some $6 billion provides a comfortable margin for Federal tax reduction, Federal programs, and more generous help to State and local units.
>
> The National Government, as a constructive partner in a creative Federal state, should help restore fiscal balance and

[25] See note 9 above. Also *U.S. News & World Report*, May 11, 1964, p. 36 and Sept. 14, 1964, p. 62.

strengthen State and local governments by making available for their use some part of our great and growing Federal tax revenues over and above existing aids.

Intensive study is now being given to methods of channeling Federal revenue to States and localities which will reinforce their independence while enlarging their capacity to serve their citizens.

The very next day Senator Goldwater urged that the Federal Government "give back to the States a share of the taxes collected from them." [26]

This dual endorsement marked the high point of a long search for an effective way to help the States. Republicans like Senator Robert Taft and then Congressman J. Caleb Boggs were leaders in that search in the later 1940's. President Eisenhower sponsored important commissions and investigations during his administration but was able to achieve little substantive reform. The pressures of budgetary surplus in the 1960's have finally turned an old dream into a very real possibility. [27]

What the presidential candidates described in general terms, the Pechman task force worked out in detail. It reportedly suggested a 1-percent return on all income tax revenues, a sum which would total $2.5 billion this year and $3.5 billion by 1970. The money would enter a trust fund—so as to keep it out of the Federal budget. It would be given in the form of an unconditional grant, subject only to basic prohibitions such as bans on construction of highways or public buildings. Most of the money (two-thirds) would be distributed according to population, the rest according to State needs.[28]

We would indicate here that many details can be worked out when a more specific plan is presented. For example, a part of the aid could be explicitly earmarked for local governments. Basic prohibitions can guard against flagrant misuse of racial discrimination. Governor Anderson has spoken of requiring a "well-developed spending plan," on the State level. Distribution formulas can be negotiated so as to achieve an acceptable and balanced program. Our endorsement is not affected by these specifics. The case we make can be applied to several variations of the plan—including the approach which was written into the Republican platform last summer. It called for credit against Federal taxes for specified State and local taxes paid. It is enough to note that our States have for years used a variety of methods for sharing tax revenues with local governments, and the experiences of the States should provide useful guidelines for the development of a Federal program.[29]

In drawing up a specific proposal, we would do well to examine the experience of countries like Canada and Australia which have made use of the "block" or "unconditional" grant to the provinces for some time. In Australia the process is fairly automatic. In Canada it is subjected to considerable negotiation every renewal period. But even there, says Professor Eckstein, it has "worked fairly well." The

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[26] *New York Times*, Oct. 28, 1964, p. 59 and Oct. 29, 1964, p. 19.

[27] For an excellent discussion of the ups and downs of the search for a greater state role see Graves, *American Intergovernmental Relations*, pp. 783–929.

[28] See note 9.

[29] Anderson, *Saturday Review*, p. 77; Republican Platform, 1964; *Advisory Commission on Intergovernmental Relations*, "A Staff Analysis of Six Alternative Ways of Distributing a Federal Surplus," Washington, D.C., Dec. 15, 1964.

last American experience with large unconditional grants came in 1837 when a $37 million surplus from the sale of public lands was distributed to the States. The assumption of State debts in 1790 was another precedent.[30]

Whatever its final form, the revenue sharing concept will help State and local units resolve a dangerous situation. It will enable them to serve the public without further burdening an exhausted tax base. It will not eliminate conditional grants but it will help those who seek to reform them. The grim threat of tax mortality and public penury will be relieved, resulting in governments of higher quality and greater stability. Commonweal magazine put it this way in an editorial last Christmas Day:

> The Heller plan, properly administered, could improve the States performance and awaken at least some of the popular interest necessary to make the system work. For arousing the people's attention there is nothing like a gift of $100 million or so.[31]

Can We Trust the States?

We cite this effect on State performance and State morale as part of our answer to critics of the plan. For by and large their objections boil down to a single cry: "We just don't trust the States." Often the cry comes from well-established Washington lobbyists who fear they will lose their influence. It also springs from entrenched administrators who would rather see more money in their own aid programs.

And some "anti-State" opposition comes from those who have lost historical perspective, who forget the States have often led the Federal Government in their willingness to change, to experiment, and to meet new problems. Many people also forget that even today the States and localities spend twice as much domestically and employ three times as many civilians as does the Government in Washington. In fact, Federal employment has fallen from 2.6 to 2.5 million since 1952 while State and local payrolls have gone from 4 to 8 million in the same period. We should not forget that scarcity of funds has not prevented the development of persuasive examples of good State and local government in the fields of education, regional and local planning, and social welfare.[32] Many straws are in the wind; they indicate that the States are in a position to make great advances. Nothing could be more effective than a revenue sharing program in accelerating these programs, and in reestablishing vital State government as a creative partner in a flexible Federal system. "If we are serious about the idea of creative federalism," says Dr. Heller, "now is the time to do something constructive about it."[33]

We would emphasize the fact that a revenue-sharing program would not in any way reduce the ability of the Federal Government to play

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[30] James A. Maxwell, "Issues in Tax Credits and Intergovernmental Relations," *Brookings Research Report No. 3,* The Brookings Institution, Washington, D.C., passim; Eckstein, *Public Finance,* p. 42. For an incisive discussion of Canadian "block" grants, see Due, *Intergovernmental Fiscal Relations,* pp. 482–484.

[31] *Commonweal,* Dec. 25, 1964, p. 437.

[32] *Wall Street Journal,* Nov. 17, 1964, p. 12. For a typical example of the "antistate" criticism, see Christopher Jencks, "Why Bail Out the States?" *New Republic,* Dec. 12, 1964, p. 8.

[33] Heilbroner, *New York Times Magazine,* p. 33.

a creative role in meeting national problems. We are not asking that all of our problem-solving eggs be placed in one basket, State or Federal. Let us look at one example. In the sense that the war on poverty is a real war, it is an all-out "crash" program which attempts to discover and eliminate basic social problems. Everyone hopes that the war will be won; no one plans that it will last forever. The Heller plan will not limit the ability of the Federal Government to fight that war; it may foster some much-needed help on the State and local level. But in the sense that poverty is a persistent and unending threat, we battle against it every day in our schools, our hospitals, our social centers. These institutions will never close, nor will our police and fire stations, our highway and welfare offices, our water filtration plants. Their wars will never be won. The revenue-sharing plan will give the States and localities the wherewithal to more adequately finance these programs—often humdrum and often taken for granted. Those who "just don't trust the States" would do well to reflect on just how much trust all of us must place in State and local government every day.

THE HOUR IS LATE

To those who suggest that Federal surpluses should be used to cut taxes, to increase Federal spending, or to reduce the national debt, we would point out that all of these ends could be pursued—the margin will probably be large enough to accommodate many desires. But we think the revenue-sharing idea more important than any of them.

Finally we would direct one comment to those who fear that the Heller plan would mean further incursions upon State prerogatives, that revenue will mean control no matter how unconditional the original grant. It would be foolish to deny that this possibility exists, but it would be equally foolish to let the matter rest there. The choice we face is not between State dollars and Federal dollars, but between Federal dollars which bear a vast array of strings and conditions—and revenues which are relatively unburdened. Only the latter alternative can now rescue us from the former. And the hour is late.[34]

Above all we appeal to Americans for a vision which sees beyond the years—beyond the realities of today and into the possibilities of tomorrow. What will our Federal system look like then? Critics from the left are convinced of Federal virtues and are suspicious of the States; critics from the right defend local government and are suspicious of Washington. But mutual suspicions must not be allowed to produce a deadlock. This country will not be governed well, her problems will not be met, unless government is alive and active and responsible at every level.

No single order of government can be fully effective unless it has the respect and cooperation of governments at all other levels. The

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[34] Professor Graves has summarized our case well when he writes on p. 911 of *American Intergovernmental Relations:* "The American Federal system has served the people well for nearly 200 years. It has great elements of strength. It has survived crises in the past and will, in all probability, survive others in the future. But there is no assurance that it will always continue to do so unless statesmanlike solutions are found—and found quickly—to meet new problems arising out of an almost completely different set of social and economic conditions under which it must operate now and in the future.

"Chief among these is the preservation, not of State's rights or of home rule in the conventional sense, but of strong and effective State and local governments as an alternative to an almost unlimited centralization of power. The time may be later than we think."

revenue-sharing proposal grows out of an awareness that the Federal and State Governments need each other. It will depend for its effectiveness upon their capacity to respect each other.

We must act now. For in the last third of the 20th century, this country will face unparalleled challenges. They can become unparalleled opportunities—but only if we confront them with sensitivity and flexibility, with firmness and with understanding. We must seek these qualities in men and in ideas—and we must embody them in programs and in institutions.

The revenue-sharing proposal can help to prepare our political system to meet the onward rush of events. It can help us to put into practice all that we mean when we speak of "cooperative federalism." It can help us to build government for tomorrow.

Section B: LOCAL NEEDS AND LIMITATIONS

REVENUE SHARING AS A MEANS OF ENCOURAGING STATE AND LOCAL GOVERNMENT REFORM

BY Representative HENRY S. REUSS (D., Wisc.)

INTRODUCTION

As the United States moves into the final third of the 20th century, it is clear that the problem of federalism is still unsolved.

In the main, State and local governments must still look after our great domestic needs—education, public safety, public health, welfare, and the future of our cities. The prospect in the years just ahead is that our growing population will demand more and better public services.

For State and local government to raise enough revenue by themselves to pay for these services is neither desirable nor likely. The State and local tax system, unlike the Federal, tends to be inequitable and inflexible. State and local governments, having greatly increased their take from regressive taxes during the past 20 years, cannot push their luck much further. Moreover, they cannot fill the future gap between needs and resources either by income taxes or by borrowing.

At the same time, even if added revenues were available, neither State governments nor local governments, hemmed in by State-imposed restrictions, are able to modernize themselves so as to use added funds effectively.

But thanks to the magic of the progressive income tax, the Federal Government will enjoy a substantial fiscal dividend as soon as the Vietnam war is settled. Properly used, this fiscal dividend can help solve both the financial and organizational problems of State and government. It can produce a creative federalism with a vital role for all three levels of our government—Federal, State and local.

I. PROPOSALS FOR HELPING STATE AND LOCAL GOVERNMENT SOLVE THEIR FISCAL CRISIS

A. TRYING TO DO IT ALL BY EXPANDING FEDERAL GRANTS-IN-AID

The present system of Federal categorical grants-in-aid—for education, welfare, commerce, transportation, housing, and community development, water and air pollution, land and water conservation, and so on—has a history as old as the Republic.

A balance sheet of the Federal grants-in-aid structure today would show several clear asset items:

1. Federal grants-in-aid let States and localities do what their people need and want, but which they otherwise lack the funds to do, in fields

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where there is a national interest such as education, health, and welfare. The alternatives—leaving the tasks go undone, or allowing an all-powerful Washington to do them directly—are avoided.

2. Federal grants-in-aid encourage local innovations which, once proved sound, can then be dispersed widely. For example, the Water Pollution Control Act of 1965 provides grants to communities which develop new methods of solving water pollution caused by combined storm and sanitary sewers. Again, the Mass Transit Act of 1964 subsidizes innovation in mass transit, such as the minibus in Washington, D.C. or the high speed rail urban transport of Pittsburgh.

3. Federal grants-in-aid help to equalize the poorer and the richer States. They enable the poorer States to afford better schools and health programs and housing than they could possibly achieve on their own.

4. Federal grants-in-aid, funded largely from the progressive Federal income tax rather than from regressive State and local property and sales taxes, improve social equity and economic soundness.

But the grant-in-aid balance sheet contains substantial liabilities, too:

1. Federal grants-in-aid often defeat State and local officials by their number and complexity, and overcompartmentalization. A 1966 survey by the Legislative Reference Service of the Library of Congress listed 162 major Federal grant programs under 399 separate authorizations. A community wishing help on its water supply has six different Federal programs to choose from, and be confused by. Sometimes the same local program requires the community's going to several different Federal agencies. A local health department, for example, which wants to innoculate children against measles, must go to the U.S. Children's Bureau for its matching funds for technicians who give the innoculations, and to the Public Health Service to obtain supples of the vaccine.

Sometimes the standards defeat even the Federal administrators of the grant programs. The Elemenary and Secondary Education Act of 1965 provided for grant aid to local school districts with substantial number of children of low-income families. The wealthy Milwaukee suburb of Whitefish Bay, with an average family income of more than $10,000, promptly applied for a grant to run a remedial reading course which it had hitherto been running with its own funds. The Office of Education allowed the grant, later explaining that it was just too much trouble to look up the census data on Whitefish Bay incomes.

Like such complexities, it is no wonder that State and local officials find kicking Washington around a favorite pastime. The larger and more enterprising State and local governments have assigned full-time staff to bird-dogging Federal grants. Some go so far as to open liaison offices in Washington. Many small local governments never hear about available Federal aids because their staffs do not include the so-called grantsmen of the larger communities.

2. The matching fund requirement, coupled with excessive compartmentalization, distorts community planning. A grant recipient may have to terminate or curtail a good locally funded program because it needs the money to provide its own 50 percent matching funds

for a Federal program that it deems much less desirable. For example, until 1966 local health departments were eligible for categorical grants for separate cancer, heart disease, and tuberculosis control, radiological health, chronic illness, dental health, mental health, home health services, and general health programs. A community with a serious tuberculosis problem, for example, may find itself diverting funds from its tuberculosis program in order to provide matching funds for the other categories.

Recognizing how this compartmentalization deprived States and localities of flexibility in health programs, Congress in 1966 wisely enacted the Comprehensive Health Planning and Public Health Services Act, under which all the programs were lumped into one, so that the recipient could concentrate on the health services most closely geared to the personal and evironmental needs of its citizens.

But 3 months later, in February 1967, the administration was back on Capitol Hill with its proposed Rat Extermination Act of 1967, providing grants to local health departments willing to combat this environmental hazard. At least one city health commissioner justifiably complained that his participation in the proposed program, with its requirement of matching funds, would necessitate curtailing his other environmental health programs, including attacks on mosquitoes, cockroaches, rabid dogs, and tick-bearing pigeons.

3. Federal grants-in-aid dull the edge of local initiative and creativity. With 162 grant programs to choose from, why search for new solutions to problems in fields not covered by the Federal grants?

4. Federal grants-in-aid frequently continue after the need for them has disappeared. For years the Agriculture Conservation Program of the Department of Agriculture paid farmers, mainly in the Prairie Pothole area of Minnesota and the Dakotas, matching funds for draining their wetlands to grow crops which were often already in surplus. Meanwhile, the Department of the Interior launched a program in the same area to subsidize farmers to undo the drainage and put their lands back into marsh, in order to give the continent's diminishing supply of ducks and geese a place to rest and nest. It took a treaty between the Departments of Agriculture and the Interior, almost as one between sovereign nations, to get the Department of Agriculture to cease and desist.

Or take the case of grants by the Federal science agencies to foreign scientists in order to stimulate research. Twenty years ago, with Europe in ashes, there was much to be said for U.S. help to revive European scientific capability. But right up until 1966, Washington continued to give grants to European scientists, including Frenchmen whose Government was working overtime to demand gold for its dollar holdings.

5. The opposite phenomenon is the turning off of Federal grant programs prematurely. In 1966, as part of the war against poverty, federally funded Small Business Development Centers were set up in the ghetto areas of a dozen American cities to work with poor but energetic minority group would-be businessmen. By teaching them the rudiments of marketing and accounting and management, and by helping them get loans, hundreds of Negro businessmen were getting a start. In early 1967, the administration abandoned and dismantled the centers. Carefully assembled small staffs were dispersed.

6. Finally, Federal categorical grants-in-aid cannot really solve the State-local fiscal crisis simply because they *are* categorical, and offer no help to the tremendous range of State and local needs which fall between the categories. Federal education programs support many worthy facets of education, but by and large they do not build local schools or pay local teachers' salaries. Two new Federal grant-in-aid programs proposed in 1967 entered the hitherto exclusive local concerns of police and fire protection. But instead of helping the central need for more and better paid policemen and firemen, they, too, flutter around the edges of research.

* * * * * * *

Altogether, Federal grants-in-aid need to be strengthened, increased, rationalized, coordinated, and simplified. But a consideration of their deficiencies as well as their virtues impels the conclusion that they cannot, by themselves, close the State-local fiscal gap.

B. Redistributing Federal Revenues to States by General Tax Reduction, Specific Tax Transfer, Tax Credits, or Tax Sharing Based Upon the Source of Collection

Critics of grants-in-aid often suggest as alternatives that Federal funds be channeled to States and localities through various tax methods. Each fortunately has a history. This will help in weighing the pros and cons of each approach.

1. REDUCING FEDERAL TAXES ACROSS THE BOARD

This is clearly attractive. It recalls the successful tax cut of 1964. Congressmen would return to their constituencies triumphantly. Businessmen would welcome expansion of consumer's disposable income. Officials of States and localities would see possibilities for raising their tax rate. Conservatives would approve of the new opportunities for choice open to private individuals, States, and localities.

But would this method in fact achieve the goal of bolstering State and local revenues? It would of course increase them indirectly, if as in 1964 it stimulated economic activity and hence national income. But the States and localities, in order to gather in more than a small fraction of the revenue, would have to resort to moves which experience has already shown to be impractical or undesirable:

(*a*) State and local governments would have to pass new tax measures. But the pressures which today inhibit them, especially from enacting progressive taxes on personal and corporate incomes, would still inhibit them after a tax reduction. The cut might furthermore cause a current of popular euphoria so strong as to dissuade many State and local officials from trying to swim against it. The fears of driving away business and of escalating tax competition with neighboring jurisdictions would remain. Thus, action at the Federal level would by no means guarantee action at the State and local levels. Nationwide results would be uneven, in the best of circumstances, with the strongest States probably benefiting most.

(*b*) Those tax hikes which State legislatures and city and county council finally passed would, if trends over the past decade continue, be mainly regressive—the sales and property taxes which bear unfairly and uneconomically upon citizens with lower incomes. More than one-third of our population lives in States which depend almost wholly on property, sales, and business taxes, and impose no individual income taxes. Several of the older industrial States (Connecticut, Illinois, Michigan, New Jersey, Ohio, and Pennsylvania) have no individual income tax, and all except New Jersey impose general sales taxes.

(*c*) Poor States would benefit less than rich States. The general reduction would give away a chance to equalize resources nationally for the benefit of all. Further, the indirect effects of a reduction on the economy and on tax bases would help the less industrialized, slower growing States less.

These reasons make the general Federal tax cut method ill designed to help the States and localities.

2. TRANSFERRING SPECIFIC FEDERAL TAX BASES TO STATES AND LOCALITIES

This approach has been studied and discussed at length since World War II, especially concerning excise taxes.

What has recent experience to say about relinquishment?

State and local governments had for years employed two such excises—the admissions tax and the electrical energy tax. Local government officials in the late forties argued strongly that the Federal Government should vacate these tax fields, which seemed especially suitable for localities. In 1951, Congress repealed the tax on electrical energy, then yielding $100 million annually. Further, it repeatedly cut back the tax on admissions. Congress acted because, according to its tax committees, the electrical energy tax was discriminating against privately owned power companies in competition with tax-exempt energy sold by public utilities and was burdening lower income groups unfairly "since amounts paid by consumers for electrical energy tend to vary relatively little with variations in income." Congress reduced the admissions tax to help a depressed industry.

But the States and localities failed to move into these fields, apparently for the same reasons which prompted Congress to vacate.

In 1958–59, the Joint Federal-State Action Committee composed of Federal executives appointed by President Eisenhower and of nine State Governors, examined proposals to end certain Federal grants-in-aid and to compensate the States by relinquishing to them certain tax sources. One candidate was local telephone service. However, the Governors argued against repealing this Federal tax outright. Repeal carried no assurance that States or localities would move into this vacated field. To guarantee the States and localities would benefit, the Governors preferred a credit against the Federal tax.

But Congress paid no heed to the committee's recommendations. James Maxwell, in a 1962 study for The Brookings Institution, explains why:

> Chiefly because the Action Committee coupled to the credit Federal withdrawal of two small Federal grant programs—voca-

tional education and construction of waste treatment facilities. This coupling not only offended supporters of the grants, but also posed an insoluble problem of establishing an equivalence, State by State, between the gain from the credit and the loss from the grants. While the allocation of the grants by States was somewhat erratic, low-income States usually received more per capita than high-income States did. Telephone tax collections, on the other hand, varied directly with State per capita income. In fiscal 1958 the per capita collection was $0.95 in Mississippi—the lowest State—and $3.48 in New York—the highest. The credit, therefore, was 3.7 times as much per capita for New York as for Mississippi. The per capita grants for Mississippi were, however, three times greater than those for New York.

These examples give little hope that States and localities would recover revenues relinquished by the Federal Government. But opportunities exist in yet other fields—motor vehicles, liquor, tobacco, and certain excises. What are the prospects there?

Motor vehicles are taxable under State general sales taxes. However, in practice several States tax them less, usually by one-half of the regular sales tax rate. In States which exempt motor vehicles from the general sales tax but levy instead a special tax, the rate is often only one-half of the general rates. No State applies rates higher than its general sales tax. This suggests that if the Federal Government were to vacate this field completely, those reasons which inhibit States now would continue to inhibit them later from raising rates up to or beyond the level of their sales taxes.

Liquor and tobacco have been taxed for many years by both Federal and State Governments. One would naturally assume, on hearing so much rhetoric about how "confiscatory" Federal tax rates on income inhibit State action in that field, that the Federal rates on tobacco and liquor would influence all States equally. But the Advisory Commission on Intergovernmental Relations, after studying the cigarette field, concluded that "it is improbable that the existence of the Federal cigarette tax affects the level of State taxation," because two States impose no tax, 12 impose less than 5 cents per pack, and 15 make off with 8 cents or more. This startling range suggests that, although repeal of the Federal tax would surely allow States to hike their rates, they could probably not do so by the full 8-cent Federal tax. That all 50 States could do so, and thus gather in all the revenues given up by the Federal Government, is even more improbable.

Excises on such consumer goods as jewelry and musicial instruments might also be relinquished. But all these items are already taxable by States and localities. States have normally used selective excise taxes only seldom, except on alcohol, tobacco, and gasoline, preferring instead to levy sales taxes at uniform rates. It seems thus unlikely that, if the Federal Government vacated this field, they would increase old or impose new taxes on these commodities. Further, lobbying pressures against these taxes would operate just as strongly at State and local levels as upon Congress.

The chances of redistributing a significant amount of Federal revenues by means of specific tax transfers therefore seem dim.

3. FEDERAL INCOME TAX CREDITS FOR STATE TAXES PAID

Taxpayers would by this method be allowed credit against their Federal income tax liability, up to a specified level, for income taxes paid to States and localities.

The Federal Government employed the tax credit twice, a generation ago, against the Federal estate tax for State death tax payments, and against the Federal unemployment insurance tax for State unemployment compensation taxes. The main motive was not to give States more revenues, but to induce the States to levy death taxes uniformly and thus avoid destructive interstate competition, and to induce States to set up uniform systems of unemployment insurance.

But in both cases, early success has given way to problems. In the death tax field, States in due course began competing with each other again. In unemployment insurance, States have adopted widely differing rates.

The main characteristic of a tax credit is that it credits not the taxing jurisdiction, but the taxpayer. The initial benefit of a credit against the Federal income tax would thus flow to individual taxpayers in those 33 States which have income taxes now. States and localities would benefit only after enacting new or higher income taxes. Relinquishing Federal revenues would thus have a highly uneven impact, largely unrelated to State needs.

By merely replacing Federal taxes with State taxes, and then only if the States act, the Federal tax credit fails to aid the poorer States.

Clearly, something should be done to curtail the competitive advantages of a State which advertises to industries and corporations "Come hither. No income taxes," and to induce States to maximize the progressive income tax. Either the carrot of the Federal tax credit, or the stick of denying Federal block grants to States without a progressive income tax, should be explored. But the Federal income tax credit would do little to solve the central financial problem of the States and localities.

4. TAX SHARING BASED UPON THE SOURCE OF COLLECTION

This proposal is modeled upon the practice in all States of sharing with its local governments all or part of the revenue from certain taxes collected in each locality. Why should not the Federal Government, also an efficient tax collector relative to many State governments, do the same? Several bills before Congress provide that the Federal treasury disburse to each State a fixed percentage, usually 1 or 2 percent, of the Federal income tax collected therein. These proposals would channel the funds both to States and to their localities, usually for such purposes as education, health, and welfare.

The fault in this type of revenue-sharing is at once clear—it fails to redistribute resources from the wealthy to the poor States. The principle of equity is recognized by the States themselves, because they generally allocate revenue to their localities upon the basis not of source of collection but of other criteria of local need, such as population.

Among the candidates for revenue-sharing based upon origin are Federal taxes levied upon income, local telephone service, and pas-

senger cars. But in all three cases, rich States would come off best by far. If 1 percent of today's Federal individual income tax revenues were returned to the States according to the amount their residents contributed, the 10 richest States would get $21 per person, the 10 poorest States only $9 per person.

If telephone tax revenues were returned on the basis of origin, over two-thirds of the collections would benefit the 10 States which are most industrialized and urbanized, but which have only one-half of the Nation's school enrollment. New York would receive $25 per pupil compared to only $5 per pupil for Mississippi.

If Federal excise revenues on passenger cars were returned, the five richest States would receive almost 40 percent of the total and the 10 richest States about 60 percent.

* * *

These four ways for redistributing Federal revenue—by reducing taxes generally, by specific tax transfer, by allowing credits against the Federal income tax, and by sharing taxes based on the source of collections—all fail to channel into States and localities financial help in amounts they sorely need. This brings us to per capita Federal block grants—the "Heller plan". It offers the best hope of meeting state-local financial needs, on an equalized basis, and with the maximum contribution to a progressive overall Federal-State-local tax system.

C. The Best Fiscal Solution—Per Capita Block Grants

Walter W. Heller has set forth the kernel of his proposal:

> In capsule, the revenue-sharing plan would distribute a specified portion of the Federal income tax to the states each year on a per capita basis, with next to no strings attached. This distribution would be over and above the existing and future conditional grants.

The some $5 billion to be made available annually would represent real fiscal relief. The per capita provision insures that the poorer States would be helped more. The distributive effect would be to draw funds from higher income groups through the progressive Federal income tax rather than from lower income people through regressive State-local sales and property taxes, and channel the funds to State-local expenditures that stress the health, education, and welfare needs of lower income people.

The Heller plan is new to Americans today. But it has several precedents—two from American history and two from contemporary use abroad.

While prosecuting the Revolutionary War, the States incurred debts of over $18 million. Shortly after adopting the Constitution, which empowered Congress "to dispose of . . . territory or other property" and "to pay the debts and provide for the . . . general welfare of the United States", Congress approved Alexander Hamilton's plan for the Federal Government to assume the States' debt. This was an important factor in placing State finances on a sound basis.

By the 1830's, during the Presidency of Andrew Jackson, customs duties and proceeds of Federal sales of public lands had not only paid off the whole national debt but had produced embarrassingly large Federal surplus. Meanwhile, States were borrowing so heavily to finance internal improvements that their debts rose from $13 million in 1820 to $174 million in 1837.

The Surplus Distribution Act of 1836 allocated surplus funds to the States in proportion to their numbers of senators and representatives—a reasonable approximation of a per capita allocation. After the third installment, the surplus disappeared in the recession of 1838. Although the $28 million distributed was ostensibly a loan, Congress clearly expected no repayments, and none were ever called for or made. Congress did not specify even generally how the States were to use the funds.

Australia and Canada, which also govern themselves by Federal systems, adopted the unconditional grant method decades ago. The distribution of functions between Federal and State Governments had gradually become misalined with the distribution of revenues, and the States proved unable to raise funds to pay their way. When the Canadian provinces federated in 1867, and the Australian states in 1901, their constitutions provided for unconditional grants from the Federal Treasury, distributing them mainly by population. Although in recent years both countries have resorted to conditional grants for specific needs, these have not been accepted as well as here. The block grant system, despite strains and periodic revisions, remains central in intergovernmental finances.

Elsewhere, Great Britain and Germany have used block grants to a lesser degree, and in limited amounts, to finance local government.

After Heller first suggested his plan in 1960, it lay fallow for several years. During the Kennedy administration, the Federal budget each year ran a deficit. But 1964 brought an upsurge in economic activity. The closing of some military bases and the reasonably stable international situation raised hopes that more Federal funds could be earmarked for social programs. The 1964 tax cut succeeded in quickening still more the pace of economic growth. These events created the possibility soon of a Federal budget surplus, with both its availability for new spending and its danger of slowing the economy by fiscal drag.

Interest in the Heller plan revived. Governors and mayors praised it. The 1964 platform of the Democratic Party proclaimed that the Federal Government should consider the "development of fiscal policies which would provide revenue sources to hard-pressed State and local governments to assist them in their responsibilities." During the election campaign which followed, both presidential nominees gave the idea general support. President Johnson declared on October 28, 1964, that "intensive study is now being given to methods of channeling Federal revenues to States and localities, which will reinforce their independence while enlarging their capacity to serve their citizens".

The intensive study was made by a task force of economists and political scientists under the chairmanship of the Director of Economic Studies at the Brookings Institution, Joseph A. Pechman. The text of the Pechman task force's report, transmitted to the President in

early November 1964, was not published. One reason attributed was supposed irritation that the report's recommendations were made public on October 28, 1964, in a front-page story in *The New York Times.*

The Heller plan aroused wide interest. In March 1965, Governors of both parties, concerned by official silence on the Pechman task force report, informally asked President Johnson to reopen study of the Heller idea. The Governors continued discussing it at their annual conference, in July 1965, and set up a Special Committee To Study Federal-State Finances, under the chairmanship of Michigan's Governor Romney.

Still, administration officials showed no signs of considering the Pechman report. By late 1965, the war in Vietnam was distracting the administration from thoughts of new initiatives elsewhere. Furthermore, it wiped out hopes for any immediate "fiscal dividend".

Another reason for White House silence on the Heller-Pechman proposal could have been the criticism which it aroused. Administrators of Federal grant programs are reported to have protested that a Heller-Pechman program, once enacted, might become an argument for Congress to cut back grant programs. A liberal criticism was distrust that States would use the funds properly. As Christopher Jencks said in *The New Republic:*

> Even a casual survey of 20th century politics suggests that the major pillars of the status quo have been the 50 states. Conversely, the major force for innovation and progress has been the Federal Government.

Labor leaders advocated instead that the revenue-expenditure gap of State and local governments be closed by increasing conditional grants-in-aid.

President Johnson in his state of the Union message to the 90th Congress on January 10, 1967, emphasized how much the Federal Government is already assisting States and localities:

> During the past 3 years we have returned to State and local governments about $40 billion in Federal aid. This year alone, 70 percent of our Federal expenditures for domestic social programs will be distributed by State and local governments.

Two months later, the President told 49 State and territorial Governors assembled in the White House that during the next 5 years Federal aid to States and localities would quadruple, to the rate of $60 billion each year.

But out in the country, Governors and mayors of both parties stepped up their support of the Heller plan. In late 1966, the Governors' Conference endorsed tax sharing by an almost unanimous vote, with only two Governors abstaining, and the National Conference of Mayors urged a tax-sharing program which would guarantee funds for their cities.

This nationwide concern over the financial health of our States and localities registered at the national level mainly in the Congress. Initiative on the Heller-Pechman proposal, although Democratic by origin, passed to the Republican Party. In the 89th Congress, 57 revenue-sharing bills were introduced, mostly by Republicans.

Most bills warned that States should use the shared funds "without any Federal direction, control, or interference." The bills all died in committee.

Within the first few weeks of the 90th Congress, bills were proposed by 85 Members, almost all Republicans. Representative Melvin R. Laird of Wisconsin, Chairman of the House Republican Conference, explained his bill in November, 1966 to the National Conference of State Legislative Leaders:

> The key is that tax sharing and block grants should be enacted into law with the stipulated intention that these programs will not supplement, but will in fact eventually replace, many of the existing categorical grant-in-aid programs presently administered by the Federal Government.

But this misses the whole point of the Heller plan—block grants to supplement, not to supplant, the present grants-in-aid for the great priorities of national need.

One answer to the Republican call for replacing Federal grant programs was shortly given by events. Faced in early 1967 with inflationary pressures and the need to free Federal funds for the Vietnam war, President Johnson cut back sharply current spending on interstate highways, about 30 percent of all Federal grants. The outcry soon produced hearings on Capitol Hill. Republican Governor Warren Knowles wrote to all Wisconsin Senators and Congressmen to warn them of "the disastrous effects" of the cut, described as "a flagrant example of too much direction from Washington." The administration shortly rescinded its cut in highway funds.

In my view, the Heller plan (together with the other proposals I have discussed) contains a central defect: while it provides an excellent solution to the *financial* problems of State-local government, it does very little to solve their *organizational and governmental* problems. With an added $5 billion or so a year to play with, State governments would have little incentive to modernize themselves and the localities they control. Federal per capita block grants could well become an oxygen tent to keep States in the hospital bed instead of getting up and trying their legs.

Attracted by the Heller plan's fiscal wisdom, but seeking for some way to jar State and local governments toward modernization, I proposed, immediately after the November 1966 election, a marriage of the two principles. After discussing the idea widely with economists and political scientists, with mayors and Governors, with Federal administrators and legislators, I introduced the idea into the 90th Congress on January 10, 1967, as H.R. 1166, "The State and Local Government Modernization Act."

II. How Block Grants Can Help To Modernize State and Local Government

In essence, H.R. 1166 provides Heller plan grants to the States of $5 billion a year, for a 3-year trial period, with no strings attached other than the one big initial string—that the State prepare in good faith a Modern Governments Program setting forth what it proposes to do in the years ahead to invigorate and modernize its own and its local governments.

A. THE ONE STRING—STATES MUST INITIATE MODERN GOVERNMENTS PROGRAMS

Each State wishing to participate under H.R. 1166 would be given Federal funds to pay the entire cost of planning. The total planning period could not exceed 2 years. If H.R. 1166 were enacted early in 1968, say, the block grants would start to flow in 1970 or 1971—when, let us hope, Vietnam will be behind us.

States would complete their plans in 18 months or less, and forward them to the appropriate Regional Coordinating Committees. The act would create four—for the east, south, midwest, and west—composed of participating Governors in each region. The Regional Coordinating Committees would review each State program. By means of a continuing Socratic dialog with State officials, the Committees would suggest improvements. By the end of 6 months, a total of 2 years of planning, each Regional Coordinating Committee would designate by majority vote those State Modern Governments Programs "which it believes reflects sufficient creative State initiative so as to qualify that State for Federal block grants."

The Committees would then forward the approved Modern Governments Programs to the President, the Congress, and the Advisory Commission on Intergovernemntal Relations. Before Congress acted, the Advisory Commission, an independent and respected body of Federal, State, and local officials, would give a second review. Only States which were designated by *both* the Regional Coordinating Committee and the Advisory Commission would be eligible for the block grants.

B. CONTENTS OF MODERN GOVERNMENTS PROGRAMS

Programs would vary from State to State according to their special needs. But the Act would direct Governors, while shaping their proposals and timetables, to tell the world what they propose to do about the following:

1. Arrangements, by interstate compact or otherwise, for dealing with interstate regional problems, including those of the 25 metropolitan areas which overlap State lines, and regional cooperation in health, education, welfare, and conservation.

Several encouraging starts have already been made. The New England States are developing joint inservice training programs, beginning with their police. The Illinois-Indiana Air Pollution Compact, the first in its field, will soon be joined by the Mid-Atlantic States Air Pollution Control Commission. Education compacts in three regions, New England, Southern, and Western, are making progress along lines urged by James B. Conant.

The Appalachia Commission administers this Federal 11-State regional program. Regional Commissions for other depressed areas have been formed under the Economic Development Act.

2. Strengthening and modernizing of State governments—by constitutional, statutory, and administrative changes—including recommendations concerning more efficient executives and legislatures, State borrowing powers, taxation and expenditures, and personnel systems.

Despite interest in constitutional reform, 37 States are still governed by constitutions drafted in the 18th or 19th century. In 28 States, statewide merit systems for employees are still lacking. Powers that ought to be centralized in the Governors are parceled out to independent boards and commissions which insulate themselves from responsibility for the *general* welfare. Far too many non-policy-making officials are still on the ballot. Legislators are poorly paid. Legislative sessions are short and infrequent. Needless restrictions on State borrowing power result in costly subterfuge.

3. Strengthening and modernizing rural, urban, and metropolitan local governments.

These can come only from the level of government which creates the local governments—the States. State constitutions, State statutes, and State administrative practices are today the principal barriers to modernizing and revitalizing local governments.

Only the States can reduce the number of, or eliminate, local governments whose cost far outweigh their effectiveness. Only the States can give localities strong executive leadership, businesslike administrative authority, personnel practices based on merit and competence, and an opportunity to move toward metropolitan government. Only the States can ease restrictions on local power to tax property and to borrow. Only the States can rationalize and make equitable their systems of local aids and shared taxes.

H.R. 1166 lists in detail the type of State reforms needed if local government is to become modern and democratic—reforms long urged by such organizations as the National League of Cities, the Committee on Economic Development, and the Advisory Commission on Intergovernmental Relations.

4. How the State would use its Federal block grants. States are no more likely to spend their funds for reckless purposes than any other level of government. But it is a good exercise for them to spell out just what they would do with the block grant. In California, the League of California Cities has already requested the Governor to work with the league in preparing plans for using the grants. The plan would have to provide for passing on *at least* 50 percent of the grants in an equitable manner to local governments. Since States now devote somewhat more than one-half of their expenditures to the localities, this provision is to prevent backsliding. It should give some muscle to organizations like the National League of Cities, which wants $125 billion in Federal block grants directly to cities in the next decade, and to mayors like Boston's John F. Collins, who has called revenue sharing with the States "the most dangerous idea in America today."

C. BLOCK GRANTS TO STATES WITH MODERN GOVERNMENTS PROGRAMS

The bill authorizes $5 billion annually for 3 years, to be distributed according to population, with not to exceed 20 percent for supplements to those States having a low per capita income; a high degree of poverty, dependency, or urbanization; and an adequate State tax effort as indicated by the amount of State and local taxes relative to personal

income. The funds would be subject to direct congressional appropriation, rather than to the "trust fund" device of the Heller plan.

Like the Heller plan, block grants to the States under H.R. 1166 would be stringless, except for the one big string that each State must file a statement of intent, its Modern Governments Program. The qualifying agents would be the Governors themselves, their Regional Coordinating Committees, and the widely respected Advisory Commission on Intergovernmental Relations.

The Act would set no statutory strings with respect to compliance with State plans. But it would require annual progress reports to Congress by the Regional Coordinating Committees and by the Advisory Commission. Moreover, the program would run initially for 3 years only. No doubt Congress, when considering whether to renew or make permanent the program, would take note of how effectively States were moving toward fulfilling their plans.

With the bait of block grants, State and local modernization would be attainable. The issue would be out in the open. A reform-minded Governor would, for the first time, have public opinion behind him. Reapportionment is bringing many new and modern legislators to the State capitols. Forty of the 50 States are planning to consider constitutional reforms within the next 2 years. Federal block grants could catalyze the movement for major constitutional and statutory reforms.

Conclusion

Twenty years ago the U.S. Government, rich with the resources of a healthy economy, saw before it governments in West Europe that were sick but capable of revival. In a mood of creative invention, we evolved the Marshall plan to place close to $5 billion a year at the disposal of the European countries. There was to be only one string to the aid, and that was a big one right at the start—that the European countries prepare programs of self-help and modernization in order to qualify. The drawing up of these programs, and their approval by the regional group of States, the Organization for European Economic Cooperation, was deemed by the Congress to be a sufficient act of faith, one which rendered unnecessary detailed performance standards. And so the Marshall plan was launched.

Today, the U.S. Government, rich with the resources of a healthy economy, sees before it State and local governments which, though capable of abundant life, are barely functioning. Is the Marshall plan analogy wholly far fetched—for the U.S. Government to place some $5 billion a year at the service of the States, with one big string—that the States prepare programs for the organizational and fiscal improvement of themselves and of their local governments? The drawing up of these programs, and their approval by the regional grouping of States, the Regional Coordinating Committees, could well be deemed by Congress an act of faith rendering unnecessary more detailed performance standards.

Perhaps it is time to try the Marshall plan principle right here at home.

A REVENUE SHARE FOR THE CITIES?

BY SELMA J. MUSHKIN*

The issue raised by the current debates on Federal tax sharing with States and cities is not whether or not more Federal aid should be granted, but rather the form that this tax sharing should take.

The central questions are: Should the additional aid go directly to the cities as well as to the States, or to the States with a redistribution to local governments? Should the additional aid have conditions and standards, or should there be no strings attached?

In this paper, the first of these two questions is discussed—the question of the return route of Federal taxes; to pass through the States, or not, in order to bring equitable benefits to the cities without violating the prerogatives of the States.

Walter Heller, in the bible on tax-sharing, "New Dimensions of Political Economy," concluded his meditations on the problem by saying, "The pass-through issue is a perplexing one. Seemingly persuasive considerations can be brought to bear on both sides of the question. How to give special weight to the claims of central cities and metropolitan areas, yet not freight the formula with too many conditions, remains a challenge to ingenuity."

A detailing of the basic assumptions and factors underlying, on the one hand, the position that the Federal Government should give direct aids to cities as well as to States and, on the other hand, the position that it should deal exclusively with the States, may help to clarify the issues.

The factors in support of allocating Federal grants directly to cities as well as to States include at least the following:

1. *The problems in the city are national problems.*—The nation's concern with eliminating poverty, with stemming the deterioration of the physical plant of cities and such national resources as air and water, and with gaining full development of their human resources, points to direct aids to cities.

2. *The large administrative tasks of providing public services to our urban population fall on cities.*—The cities at present bear the major costs of critical public services despite their limited taxing authority, heavy dependence on property taxes, and difficulties in levying charges on commuters! The cities, not the States, can best tailor their public services to meet the special needs of the cities' residents.

3. *The National Government rather than the State is responsive to city problems.*—Exclusive dealing of the National Government with the States would reverse the direction of existing tax-sharing

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policies and limit the responsiveness of the National Congress to city needs.

4. *A workable formula can be developed for direct aid to cities.*—A formula that would reflect a reasonable division of the additional tax sharing between States and cities, and would allocate funds among cities, in an equitable and objective way, can be designed despite the variety of technical problems involved.

The assumptions and factors in support of having the Federal Government deal exclusively with the States include at least the following:

1. *States are responsible for their localities.*—The strength of our federal system of government depends on a firm adherence to the legal doctrine of this State responsibility.

2. *There is need to strengthen State government.*—The viability of our federal system of government requires the State government be substantially strengthened; the channeling of all Federal aids through the States would be a move in this direction.

3. *States are responsive to urban problems.*—States share a substantial part of their revenues with localities. In the presence of improvements in program planning at the State level and the recent reapportionment of State legislatures, the States will be responsive to the relative needs of urban areas.

4. *It is feasible to establish an objective pass-through provision that would assure funds to localities.*—Conditions on pass-through of funds to local governments can be included in federal grants to the States even though there are substantial technical problems at the national level in defining an equitable pass-through provision.

I. The Pass-through

Let us review these considerations briefly, starting with the factors pointing to a pass-through through the States.

State legal responsibility for cities coupled with improved State legislative responsiveness to the urban voter as a consequence of reapportionment has led to the assumption, by some, that States will provide the financial support required to meet the recognized urban problems.

States have shared a sizable part of their revenues with local governments. In 1965 State aid reached $14.1 billion and accounted for almost 30 percent of local general revenues. The growth in State aids to localities points to a sharing of additional Federal revenues with cities.

In the past State aid formulas have favored rural areas. In 1965, for example, State aid amounted to $2 for each $5 raised by localities other than cities. But changes in formulas are being made and larger amounts of aid are going to the larger cities. In the fiscal year 1961, State aid amounted to over $1 for each $5 raised by cities with populations of one-half million or over from own sources; by 1965 these aids exceeded $1 for each $4 raised from own funds. And the ratio of State aid to own funds increased almost progressively with city size from $1 for each $5 raised in cities with populations below 50,000 to over $1 for each $4 in cities with populations in excess of half a million.

Even if one has little faith in the voluntary responsiveness of State

government to urban problems, it is argued that conditions can be built into Federal grants to States to insure proper distribution of the Federal resources to the cities.

Proposals for added Federal tax sharing differ markedly in the extent to which they specify a requirement that the States share them with local governments. Some of the proposals leave to the discretion of the States the reallocation of the additional Federal funds; one requires that the States must distribute to their local governments an equitable proportion of the added Federal funds with the ratio in each State to be no less than the average of the State's distribution of its own revenues to local governments in a preceding period. Still other proposals call for each State to reallocate a designated proportion of the added Federal tax sharing, e.g., 50 percent to localities. Still another would require State plan submissions for the reallocation of added Federal grants.

The pass-through raises two separate questions: (1) the proportion of the total amount to a State that is to be reallocated to local governments, and (2) the way in which the funds are to be apportioned among the qualifying local governments.

A uniform rule for all the States on the proportion of the Federal tax sharing to go to localities is deemed to be inappropriate because of the wide variations among States in the relative sharing of responsibilities for major governmental functions. In some instances welfare programs are State programs financed out of State funds; in other States, localities help finance the program. Arrangements for sharing educational expenditures differ markedly. In a few instances the major educational expenditures are financed by the State; at the other extreme, in a few States, State financing is very restricted.

In the aggregate, in fiscal 1965, States collected 41.4 percent of the $74 billion State and local general revenues and spent directly only 35.1 percent of the general expenditures of States and localities. But within these aggregates there is wide variation in the State-local revenue and expenditure relationships and in State aids to localities. In some States grants to localities account for over 50 percent of State general expenditures; in a few they account for less than 15 percent.

The wide differences among the States, both in allocation of program responsibility between State and local governments and in State aid practices, hamper the design of a uniform formula and make it difficult to specify a uniform nationwide rule for reserving funds for local use.

In view of these variations it has been urged that a minimum percentage be set, such as 40 percent, as a floor on State sharing of additional Federal revenues with localities—a percentage in excess of the existing nationwide average sharing. While due recognition has been given to the possible conversion, in practice, of such a minimum requirement to a maximum, the setting of the proportionate share at a sufficiently high ratio, it has been argued, would offset any undesirable consequences for local finances.

A statutory provision requiring each state to share with localities, a specified fraction of the funds from Federal tax sharing is not adequate to safeguard funds for cities. All local governments and, indeed, local functional agencies such as educational agencies become appro-

priate State recipients of added Federal tax sharing. State use of a designated part of the total new funds for city aids is likely to meet with the same opposition in State legislatures as does special taxing or bonding authority for cities, or special aids to cities out of State funds.

Reallocation requirements alone thus will not achieve substantial aid for cities. The use of information on past distributions to localities by the States, such as State grants in a previous 5-year period, would maintain past rural biases in most States. Aid distribution formulas for educational purposes, in many, if not most, States have foundation provisions that take account of the low property assessments in farm areas. Proportionately more of the funds go to rural parts of the State than to urban; the use of past distributions as a standard would accordingly freeze the biases in reallocations of new Federal tax sharing.

In any case such a Federal standard would require definition of what types of payments to the local governments are to be counted as grants. Should one include shared taxes; taxes collected by the States for local governments; payments under State programs of uniform amounts for specific groups of beneficiaries, such as State payments of $300 for each home bound child of school age? Grants are difficult to define rigorously but such a definition would have to be developed for the purposes of administering a pass-through standard based on historical experience.

The alternative of requiring the development of a "State plan" for reallocation of additional Federal tax sharing instead of setting a statutory standard would still require the development of criteria for distribution. Such a plan provision permits the reallocations to be determined in the light of the special characteristics of the State. However, in effect it passes the hard decisions of allocation to the States; the State must determine which local jurisdictions are to receive aid, and how much they are to get. Are special districts to qualify for reallocations of the additional Federal tax sharing? Or is the added tax sharing to go to central governments only, such as municipalities and townships? Are consolidation of local governments and interjurisdictional cooperation to be encouraged by the reallocation or is the existing local government structure to be buttressed and reinforced by the additional aid? Objective guides to allocation that would permit the making of equitable rules, once identified, can be quantified approximately and Federal formulas substituted.

Policing of compliance with a State plan for allocation is difficult. Even if it were possible to trace through the particular dollars of the additional Federal tax sharing this allocation itself would hardly be sufficient. States may elect to take account of the additional Federal tax sharing in deciding their own grant-to-localities policies. Moreover, conditions change; population growth in one part of the State may be double that in another; consolidated schools may result in school outlays in one locality rather than another. New programs for community mental health may be established, changing the requirements for State support of the mentally ill. It will be impossible to determine, after a period of time whether the total State allocations to local governments, including the Federal tax sharing, is different from what that allocation would have been without the sharing.

More importantly, the pass-through provision does not recognize the special responsibilities of the National Government for certain public services in the cities. A uniform per capita reallocation by the States to local governments would certainly be acceptable (within a Federal tax sharing plan that called for a uniform per capita grant to States). But such uniform amounts do not take account of the higher costs and scope of public services in large cities: nor do they take account of the deteriorating circumstances in many cities that require higher outlays just to stay even.

While much of the emphasis on pass-through requirements as a part of a proposal for additional Federal tax sharing arises out of the concern for the plight in the cities, a pass-through through the States cannot achieve the desired assurance of funds for cities.

Our functional system of Federal aids has grown in response to pressures from the citizen-voter and the interest groups with which he has aligned himself for political action on such specific programs as clean water, urban renewal, mass transportation facilities, and the preservational open spaces. These purposes have been sought by political action at all levels of government—local, State, and National. The grant programs offer a way for the U.S. Congress to respond to these pressures and to achieve the program purpose sought.

Weaknesses of the State governments have reinforced the pressures for national action and for the use of the grant-in-aid as an instrument to alleviate and remedy the social and economic problems in cities. Inadequate representation of cities in State legislatures has caused cities to turn to Washington for aid—and as many mayors recently made clear in their testimony before the Senate Subcommittee on Intergovernmental Relations, they have had more response from the Congress than from their State capitals.

Direct Federal aids to cities exceeded one-half billion dollars in 1965, and direct aid to all types of local governments amounted to $1.2 billion that year. By 1968 these direct grants to local urban governments will have risen to in excess of $3 billion and by 1970 to well in excess of $3.5 billion.

II. DIRECT AID TO CITIES

Now let us turn the problem about and address ourselves to the question of direct aids to both States and cities. The major issues again are—

1. What share of the funds are to go to cities?
2. What jurisdictions are to be eligible?
3. How should the funds be allocated to eligible jurisdictions?

I am setting aside the first of these questions because objective guidelines for determining a division of additional Federal funds between States and cities are not available. The share of the added grant, if it were to go directly to cities, would necessarily be set arbitrarily, but with due recognition of the larger requirements in central cities on the one hand and, on the other hand, the continuing need for a pass-through of Federal funds from State to local governments that are not eligible for direct Federal assistance, on the other.

Resolution of the division between States and cities of an aggregate grant, for example, a 50–50 splitting of funds, still leaves a number

of technical distribution problems. It is notably difficult to achieve an equitable and feasible distribution formula for direct Federal grants to localities. Whatever definition for an eligible jurisdiction is chosen will essentially be arbitrary. Should all cities regardless of size be eligible? Should only middle size cities and large cities with their higher costs qualify? Should all local units of a specified or greater size receive funds? The arbitrariness, whatever definition and cutoff points are selected, raises obvious problems. No matter which jurisdictions are awarded grants, those which do not receive funds will regard themselves as being discriminated against.

Among the States there is an uneven distribution in the size and number of cities. A few States possibly may contain no cities qualifying for the direct city aids. This inequality among States will lead to strong opposition from those who would receive little or no aid to cities.

A separate problem arises from the unequal impact on the budgets of these cities that qualify of a uniform formula for distribution of Federal funds. A single grant formula allocating moneys among numerous cities, with different public program responsibilities, different population concentrations, different histories and fiscal patterns, will not yield uniform Federal sharing of expenditures. We can identify the problems and their sources outside the city which are really national and not city problems: the ill-prepared immigrant embodying prior underinvestment in education, health, and other public services by far-removed jurisdictions; the commuter, utilizing, demanding, and creating a need for public service expenditures within the central city, contributing little, but residing outside and paying taxes to other jurisdictions; congestion and density making necessary greater uses of resources to maintain some acceptable level of program services. However, there is at present no pragmatic, objective way of costing the intensity of each problem in each city so as to yield a precise apportionment formula. In the face of the lack of such a formula, the distribution of funds among the cities would essentially do rough justice.

A uniform formula may call for equal per capita amounts, or equal per capita amounts weighted by population densities or other factors. Allocation formulas, for example, may take account of (*a*) a variety of population characteristics such as: the number of low-income families, the number of unemployed or the number of nonwhites, as well as population density, or (*b*) relative public service pressures such as crime rates, number of substandard dwelling units, number of assistance recipients, or (*c*) a weighting system can be designed to reflect the presence or absence of such expenditures as education, health and hospital outlays, and public assistance payments.

Nevertheless, because of the result of the distribution of expenditure, and of revenue, responsibility for various public services between the State government and its localities varies so widely from any national "average" that the result of application across the Nation of a uniform formula will be grant support for unequal proportions of the city budgets.

A direct grant to existing city governments within metropolitan areas may impair effective governmental cooperation or consolidation.

The present fragmentation of metropolitan economic units into a multitude of separately responsible governments creates a great need for metropolitan-wide interjurisdictional cooperation. A grant directly to qualifying cities may serve merely to prop up an outdated and inefficient institutional arrangement and to impair rather than strengthen regional forms of government which have attempted to cope on a broader base with metropolitan problems. Any measure dealing with the problems of the cities must include incentives for metropolitan area intergovernmental cooperation, and not the reverse.

Whatever the allocation formula it should not freeze undesirable governmental patterns, create a barrier to consolidation of governments or interjurisdictional cooperation, give substantial additional support to wealthy suburban areas such as Shaker Heights, Ohio or Somerset, Md., penalize those cities making greater taxing efforts, or unduly encourage State readjustment of said formulas to their cities that would counteract the effect of added Federal aid.

Direct aid to cities poses sharply questions of who is eligible and what the allocation formulas should be. In a pass-through these questions are buried somewhat behind the State screen but they are not avoided. The questions however, are no more difficult than any eligibility provision under a Federal statue. Whether the legislation concerns income taxation with its $600 personal exemption per person, or OASD with its six quarters of coverage out of the last 12, there are always cutoff points distinguishing the "ins" from the "outs."

Furthermore, considerations on formulas should not obscure the defining of objectives in a general support grant to States on the one hand and cities on the other. In the one case a complement to categorical aids is sought to gain flexibility in State programing that can give depth and a balance to these aids and make them work more effectively. In the case of the cities a large injection of new moneys is sought; moneys that are not limited to capital outlay aid but are in a sense an indemnity to the cities for the costs arising out of population migrations that contribute to the extra crime rates in central cities, their welfare loads, public hospital use and physical deterioration.

LOCAL GOVERNMENT FISCAL REFORM: THE NATIONAL VIEWPOINT

BY L. L. ECKER-RACZ*

We have much ground to cover this morning. The time allotted us will perhaps suffice for stating our conclusions, not for the evidence that supports them. As the first man "on", I should use some of my time to define the problem, place it in perspective.

Local fiscal reform is not a new need. It probably is as old as the institution of local government itself. What is new is its gravity and urgency. And ironically, it is national growth and prosperity that makes the need for local fiscal reform critically urgent.

National economic growth feeds on local government activity and in turn generates demand for more of that activity.

Currently local governments are spending at an annual rate of about $50 billion; they account for more than 8 percent of the gross national product. They employ more than 5½ million people—over twice the number of Federal civilian employees; almost three times the number employed by State government. Local employment accounts for about 7½ percent of the total civilian labor force and each month pumps over $2½ billion of wages and salaries into the income stream. Local government's investment in new school buildings, city halls, county courthouses, hospitals, water and sewage systems, and streets and roads now aggregates over $10 billion a year. Most of this involves contracting and contributes significantly to private employment and payrolls. And to finance this capital outlay and associated land acquisitions, local governments borrow annually some $8 billion from private investors. These are some of the ways local governments contribute to the GNP.

Increased economic activity in turn creates demand for more local government spending. It stimulates the business community's need for more municipal facilities and services; it prompts business management to insist on better environmental conditions for its employees, on better schools for its employees' children, on better health facilities for its employees' families.

National economic prosperity impinges on local revenue needs from other directions as well. An economically affluent population demands and expects better education, cultural and recreation facilities, and better protection services. Economic prosperity, moreover, enables the National Government to focus on social objectives that operate in the same direction. You need no reminder that the national administration's present emphasis on the Great Society with its antipoverty,

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urban renewal, beautification, and open space programs—made possible because national defense needs no longer preempt a rising proportion of the country's growing output—has important implications for your respective communities' budgets.

Again, there is nothing new or different in the phenomenon that national prosperity generates new national obligations. Economic affluence, public and private, bestows both bounties and burdens. What is unique with respect to the public sector in the American situation is that the fiscal bounties of prosperity tend to be national, while its fiscal burdens tend to be local. This is so because under this Federal system, the lion's share of the responsibility for civilian governmental services falls first on local government then on State government and only when both default, on the National Government. The tax revenue byproduct of economic growth, on the other hand, accrues disproportionately to the National Government.

While responsibility for most civilian functions of government are local, the interest in the quality and adequacy of these services is very much national. There is no need to belabor the fact that communities in the North, South, East, and West are tightly interrelated, and grow progressively more so with the accelerating interdependence of the economy and the growing mobility of the American people. Inevitably, the quality of education and other public services provided by one community is reflected in the quality of the work force and in the welfare load of other communities hundreds and thousands of miles away.

Even the American image is affected by what occurs in local communities. When American citizens' civil rights are abridged, when crime and juvenile delinquency make headlines, when blight festers in the cities, the international view of the American dream is sullied. In this age of communication satellites, America's linen, the soiled with the clean, is on the line for all the world to see.

Each of you can testify to the relationship between national prosperity and local government's revenue needs out of your own budgetary experience. In the last 10 years alone, the direct general expenditures of local governments increased by 130 percent, expenditures for personal services by 140 percent, and the indebtedness by 150 percent. During this same 10-year period, the national output of goods, and services increased by about 60 percent.

Since local government's expenditures tend to grow nearly twice as fast as the national economy while property tax collections do well to keep pace with economic growth, local budgets suffer from chronic imbalance. Since revenue requirements rise faster than the yield of existing taxes, the deficiency grows progressively wider and can be bridged only by additional taxation and increased intergovernmental aid. The 115-percent increase in local tax collections during the past 10 years was achieved only with benefit of new tax enactments and higher tax rates.

The irony that increased national prosperity necessarily spells aggravated fiscal problems for local governments is an inevitable consequence of this Federal form of government. Of all types of taxes in general use, only the income tax can be designed so as to produce at a rate that approximates the spending growth that accompanies eco-

nomic growth, and most local governments are neither free nor able to utilize income taxes so as to exploit their revenue potential. Effective income taxation, effective in terms both of productivity and equity, is uniquely the National Government's monopoly—by virtue of its exercise of taxing jurisdiction over the entire country and over "income from whatever source derived."

The disparity between the local and national shares of the fiscal bounties and fiscal burdens produced does not arise in unitary systems because those national governments are free to finance essential civilian services, whether provided locally or nationally, out of national revenues. Under our system, however, the diversion of national revenues to financing civilian functions labors against important restraints. We want to vest responsibility for spending close to the people at the local level and we want the taxing responsibility to accompany the responsibility to spend, so that those who have the pleasure of spending assume the onus of taxing. The American system does provide, to be sure, for interlevel financial aid, but we want the role of grants kept to a minimum in deference to our dislike for centralization and our affinity for home rule.

Under the pressure of postwar developments, State aid to local governments and Federal aid to State and local governments have both increased. But their relative role in local government financing has not appreciably changed. Somewhat more than one-fourth of the $50 billion local governments spend annually is financed by State and Federal grants. Some of the newest Federal grant-in-aid programs—antipoverty, mass transportation, urban renewal—are directed especially at community action. These programs, however, contribute less to easing the strains on local governments than is generally assumed because they require local matching and the commitment of local revenues to programs which might have rated relatively low priority in the absence of Federal grants.

It requires no clairvoyance to predict that as national economic growth continues, America will need to reconcile itself to more and more Federal financial aid, and that States will need to assume financial responsibility for increasing shares of local needs. It is equally clear that the pace of this reconciliation will be materially affected by local fiscal reform. At both the National and State level, the case for financial aid will be strengthened as local governments demonstrate that they have utilized and exhausted their own resources. By the same token, those who would minimize State and Federal grants will realize their hopes only as local governments make more effective use of their own taxes and of the dollars their taxes produce.

One can identify at least three distinct facets of this problem: One is the need to maximize the effective use of moneys already available to local governments. Tools and techniques for assessing the comparative effectiveness of alternative public expenditure programs still remain to be perfected. Another is the need for local governments to make effective use of taxing powers already available to them. Finally, local government needs to be restructured into general-purpose governmental units large enough for reasonable efficiency in present circumstances; alternatively, there is need to develop techniques of interjurisdictional cooperation, to secure reasonable efficiency despite frac-

tionated political jurisdictions. The most pressing need in this regard is in urban centers where progressively more and more Americans are clustering across far too many, too small, and overlapping governmental jurisdictions.

Since there is a national interest in adequate governmental performance at the local level there is also a national concern with maximizing the revenue potential of local governments. Much of the work of the Advisory Commission on Intergovernmental Relations has been directed to this end.

The 26-member Advisory Commission was created by Congress in 1959 for several purposes, including these:

> To bring together representatives of the Federal, State, and local governments for consideration of common problems;
>
> To encourage discussion and study at an early stage of emerging public problems that are likely to require intergovernmental cooperation;
>
> To recommend, within the framework of the Constitution, the most desirable allocation of governmental functions, responsibilities, and revenues among the several levels of government; and
>
> To recommend methods of coordinating and simplifying tax laws and administrative practices to achieve a more orderly and less competitive fiscal relationship between the levels of government and to reduce the burden of compliance for taxpayers.

Since the Commission consists primarily of Federal, State, and local executive and legislative leaders, it looks at intergovernmental problems from diverse points of view. With all levels of government in mind, it has been developing piece by piece a program of fiscal reform.

Local government is the creation of the State and its very existence depends upon State legislative action. Its structural form, its powers and responsibilities, the way it can raise revenue and borrow, even the titles and salaries of its officials—all are set forth in more or less detail in State constitutions and statutes. Some local governments have been granted "home rule" but even home rule charters are circumscribed by State law. Therefore, it is at the State level that local fiscal reform will have to be initiated, and it is to the States that much of the Advisory Commisison's counsel in his area has been directed.

The Commission's recommendations for strengthening local government call for three general courses of action by the States: (1) unshackling their local governments; (2) assisting their local governments; and (3) overseeing their local governments.

Unshackling the Fiscal Restrictions on Local Government

The Commission has looked in some detail at two of the traditional ways in which State constitutions and statutes tie the hands of local finance officers in their efforts to provide the money their governments need to operate effectively—the restrictions on local taxing and borrowing powers.[1]

Both tax and debt limits are relics of the 19th century, long before modern devices for fiscal control were conceived. In the tax field they

[1] *State Constitutional and Statutory Restrictions on Local Government Debt* (A-10), September 1961: and *State Constitutional and Statutory Restrictions on Local Taxing Powers* (A-14), October 1962.

typically take the form of a percentage of the locally assessed valuation as the limit above which property tax mill rates may not be raised. These property tax limitations have had little or no effect upon the ability of local governments to increase property tax revenue. They have challenged local officials to use their ingenuity in finding means of getting around them and officials have not been found wanting for devices to do so. The methods are familiar to you: special district financing, short-term borrowing to finance deficits that are ultimately funded, special limitations applicable to particular functions, etc. The Commission concluded that modern budgeting and other fiscal controls eliminate the need for property tax limitations and that our State-local governmental system would be far better off without them.

On the other hand, the Commission does not recommend unlimited proliferation of locally administered income, sales, excise, and similar nonproperty taxes. Such taxes should encompass broader geographic areas than are usually covered by local communities. Where local property taxes have become so burdensome as to necessitate the extension of local taxing powers to nonproperty taxes, the States should allow local supplements to their own broad-based taxes. At the very least they should provide for joint administration of local nonproperty taxes by contiguous local governments that comprise an integrated economic unit.

Debt limits, which like property tax limitations are often tied to assessed valuations, have also come under the Commission's scrutiny and have been found wanting. They have been subject to the same abuses as property tax limitations. Much of the "nondebt" debt has been issued at additional cost to the taxpayer, to evade the constitutional and statutory limitations. There are better, more sophisticated ways of overseeing and helping local government borrowing operations, and the Advisory Commission recommends repeal of the traditional debt limits. The Commission also feels that the authority of local governing bodies to issue debt should be subject only to permissive referendum, on petition, and that the results of such a referendum should be determined by a simple majority vote.

Assisting Local Governments

As the States build up their own technical expertise they should be in a position to provide valuable assistance to their local governments, particularly the smaller ones, in the various aspects of financial administration. Two fields, in particular, lend themselves to State participation through technical assistance—the investment of idle funds and debt management. The Advisory Commission has studied these aspects of local fiscal administration and made a number of suggestions.[2]

In a number of States, local governments do not even have adequate authority to invest their temporarily idle funds in interest-bearing securities. This is an oversight the Sates can and should correct. Having provided local governments with this important fiscal tool, States should also help them by identifying available investment

[2] *Investment of Idle Cash Balances by State and Local Governments* (A–3), January 1961; and *State Technical Assistance to Local Debt Management* (M–26), January 1965.

opportunities, including short-term Federal securities, savings and loan shares, and the like. The Advisory Commission has cooperated with the Treasury Department in preparing a brochure describing the various kinds of short-term Federal issues available for the investment of public funds. Millions of dollars are lost to local governments annually because they do not have the legal power to invest their funds or because they are not aware of the investment opportunities.

Municipal finance officers need hardly be reminded of the highly technical problems connected with debt management and of the pitfalls that beset the uninitiated. Local governments, particularly the small ones that come to the money market infrequently, need help when they issue bonds, and the States should be in a position to provide such help. The Advisory Commission has outlined a program for State technical assistance to local debt management which could well enhance the quality of local debt offerings and reduce their interest costs. Under the Commission's program, States would provide the following kinds of debt management assistance to their local governments:

Development and maintenance of a State file on local debt and related data;

Dissemination of data on local government finances;

Preparation of standards for official statements on local debt offerings;

Development of an educational program for local finance officials;

Advisory review of both the legal and fiscal aspects of proposed local bond issues; and

Optional State sale of local bonds.

Overseeing Local Government Finances

There are some facets of local finance in which the States' stake is so overriding as to demand State participation far beyond technical assistance. Property tax administration is a case in point. The property tax is and in the foreseeable future will continue to be by far the most important source of local revenue. It produces $7 out of every $8 collected by local governments and has performed well since World War II. Its yield has almost matched, dollar for dollar, the aggregate yield of all variety of State taxes. In many areas, to be sure, it is exhibiting strains. Where rates are relatively high, homeowners are pressing for tax relief and industry is beginning to weigh tax rate differentials in making location decisions. In these situations, poor and inequitable administration is particularly perilous.

You are probably familiar with the Commission's property tax study conducted by Dr. and Mrs. Fredrick Bird.[3] The Commission uncovered no new startling facts about property tax administration. Its study crystallized what has been common knowledge for a long time: that many assessment jurisdictions are too small for efficient administration; that much of the property tax assessment is conducted in a nonprofessional manner by elected, untrained officials; that the property

[3] *The Role of the States in Strengthening the Property Tax* (A-17), June 1963.

tax base is being eroded by a conglomeration of exemptions; that assessments are inequitable because of poor or nonexistent equalization procedures, and that taxpayers have inadequate protection against assessment discrimination. When the States vacated the property tax for exclusively local use during the 1920's and 1930's, it was hailed as a step toward "separation of tax sources." This proved to be a mixed blessing, for the States also lost interest in maintaining the quality of property tax administration.

It is the Commission's view that the States will have to take vigorous action to revamp their property tax laws and its report sets forth 29 recommendations for State action. These run the gamut from a reexamination of the role of the property tax in the State-local tax structure, to reorganization of State and local property tax assessment administration, to setting up reasonable assessment review and taxpayer appeal procedures.

Property tax administration is one governmental area in which our time-honored attachment to home rule is misplaced. When each local jurisdiction is left free to apply its own political judgment to the way property should be assessed and taxed in a society in which property is becoming more specialized and intercommunity relationships increasingly more sensitive, the quality of property tax administration suffers. What is needed is a State-local partnership, with the State as senior partner.

Another case in point is the use of local government borrowing powers to finance the acquisition of plants for lease to private industry. You are all familiar with the highly publicized industrial development bond device. Its potential for abuse is well known: large, financially strong national companies taking advantage of municipal governments' tax exemption for their private gain; small communities overextending their credit to entice industry from others, and in the process overstraining their revenue resources to meet unanticipated demands for public services.

The use of local industrial development bond financing was started over a quarter of a century ago in Mississippi and after World War II the idea was emulated by other Southern States. Some of the Northern industrial States began to be concerned about the loss of industry to the South and a few of them entered the industrial development bond field. Now about three-fifths of the States engage in the practice.

The Advisory Commission concluded that unless the States control their local governments' activities in this area, the system will topple of its own weight and in the process will do irreparable damage to local finances.[4]

The States can avoid this eventuality by providing a number of safeguards. They should—

Subject all industrial development bond issues to approval by a State supervising agency;

Restrict authority to issue such bonds to local units of general government (counties, municipalities, and organized townships);

Limit the total amount of such bonds that may be outstanding at any one time in the State;

[4] *Industrial Development Bond Financing* (A–18), June 1963.

Prohibit such financing for pirating of industrial plants by one community from another; and

Provide machinery for informing the public as to proposed industrial development bond projects, and to enable citizens to initiate referendums on such projects.

FISCAL DISPARITIES BETWEEN CENTRAL CITIES AND SUBURBS

The revenue problems of local governments stem in part from fiscal disparities between central cities and their suburbs. The persistence of these disparities means that individuals living in different communities in the same metropolitan area can provide themselves with roughly comparable levels of public services only at the expense of highly disparate tax burdens. In view of the limitations on how far individual communities can push their tax rates above prevailing levels, the actual result of disparities is such as to force the poorer communities to forego high levels of education and other essential government services.

Fiscal disparities among communities may arise because the costs of similar service levels differ or because fiscal capacities are unequal. Obviously, these two factors may cancel out or they may reinforce each other, depending on the particular situation. On the expenditure side, identical facilities and programs tend to be more expensive in central cities than in suburban communities. Moreover, programs are not always identical in suburbs and cities. Education and welfare programs are generally costlier in the core city.

In recognition of this, the Advisory Commission is urging the States to insure that school grant formulas provide for an educational level below which no community system may fall, and they take account of the factors that cause per pupil costs to vary from community to community.

Certain State policies may aggravate differences in the costs of public services by encouraging the proliferation of small governmental units. If the most efficient administrative unit for a particular program is fairly large—say the county—a State policy that makes grant-in-aid available on the same basis to all incorporated units of government, however small, will result in higher program costs because of inefficiency.

In addition, the Commission is urging the States to eliminate all features of grants-in-aid, shared taxes, and authorization for local nonproperty taxes that tend to aggravate disparities in local fiscal capacity and that encourage the proliferation of local governments in metropolitan areas.

The unequal distribution of the property tax base among local governments within a metropolitan area is partially responsible for both the disparities of public service levels and variations in tax burdens and these variations, in turn, create a fiscal climate hostile to the solution of the basic political problem—the fractured unity of the metropolitan area. For example, the citizenry of the local government with the relatively low tax burden is apt to look with special disfavor on any proposal to merge with a government that has a high tax burden, particularly if the proposed annexation or consolidation would not materially raise public service levels.

In order to create a fiscal environment more hospitable to the solution of the basic metropolitan political problem, States could shape their grant program to promote greater uniformity in tax burdens and service levels with metropolitan areas. A general purpose grant program weighted in favor of communities carrying the heaviest tax burdens would tend to smooth out the fiscal contours of the metropolitan landscape and thereby facilitate solution of the metropolitan problem from within.

* * *

Time does not permit the detailing of other Commission proposals that reflect the vital national interest in strong local governments. Without adequate financing, local governments cannot begin to provide the essential services in the quantity and quality demanded by a steadily growing and urbanizing population and an increasingly complex society. The Federal Government can help through its grant-in-aid programs. However, it is the States that will have to take vigorous action in providing the fiscal powers local governments need to discharge their responsibility, in offering them technical assistance, and in supervising them in those areas where they cannot be allowed to go astray. If time permitted, I would take another half hour of your time to underscore the truism that States are able to discharge their obligations in behalf of local government fiscal strength only as they strengthen their own revenue systems.

HOW METROPOLITAN ARE FEDERAL AND STATE POLICIES?*

BY NORMAN BECKMAN**

A great part of the study of problems of governmental fragmentation in metropolitan areas has been directed to local government restructuring and consolidation. Less attention has been given to the role of the Federal and State governments in overcoming the consequences of fragmentation. The author here focuses on this vertical dimension of intergovernmental relations by (a) describing how Federal and State Governments are playing an increasing and essential role in encouraging action which meets the criteria of geographic adequacy to perform services, economies of scale, equitable financing, and political accountability, which are the real goals of sound local government in metropolitan areas, and (b) identifying areas for improved Federal and State practice to achieve these objectives.

Like the weather, everybody talks about the need for restructuring local government in metropolitan areas but nobody does anything about it. In the words of Thomas Reed, "So far we have accomplished little more than the world's record for words in proportion to cures effected."[1] The problems are real enough: uneven allocation of fiscal resources among the many local governments in a metropolitan area, disparities in levels of service among central city and suburban jurisdictions, economically inefficient scale of operation, excessive spillover of costs and benefits, and unresolved areawide problems.

Heavy emphasis in the extensive literature to date has been on the use of intrametropolitan machinery—annexation, extraterritorial powers, interlocal contracting, councils of governments, urban counties, control of special districts, and city-county consolidations, etc.[2] Less attention has been given to the vertical (Federal-State-local, Federal-local, State-local) dimension in which all governments in metropolitan areas must also operate; yet both the horizontal and the vertical systems of intergovernmental relationships should be understood before creation of alternative structure is recommended. Even the severest critics must admit that, like the bumblebee and the old "PBY," however imperfect or illogical, the present system does work. For this, State and Federal governments must get a large share of the credit.

This article is designed, first, to describe how Federal and State agencies play an increasing, essential role in encouraging action which

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**Advisory Commission on Intergovernmental Relations.

[1] Thomas H. Reed, "Hope for Suburbanitis," *National Civic Review*, December 1950, p. 542.

[2] See Roscoe C. Martin, *Metropolis in Transition: Local Government Adaptation to Changing Urban Needs* (Housing and Home Finance Agency, Washington, D.C., September 1963) for a series of contemporary case studies, and Advisory Commission on Intergovernmental Relations, *Alternative Approaches to Governmental Reorganization in Metropolitan Areas* (Washington, D.C.: Government Printing Office, June 1962) on the strengths and weaknesses of 10 such reorganization approaches.

meets the following criteria for sound local government in metropolitan areas—*geographic adequacy, economies of scale, adequate and equitable revenue sources, and responsibility to the public for a wide range of functions;* the second, to identify some areas for improved Federal and State practice in achieving these objectives. The attempt is to document and explain changes in Federal and State policies developed largely in the last 5 to 10 years toward urban development and governments in metropolitan areas; policies which, like Mr. Disraeli's empire, are being acquired in a fit of absentmindedness.

Geographic Adequacy

Governments performing urban services should have a geographic area of jurisdiction adequate for effective performance. For many governmental functions today, particularly those concerned with natural resources, the environment, and communication, area is crucial to effectiveness. Yet, since logical service areas for different functions and subfunctions vary, no "set" of boundaries for local governments is demonstrably more satisfactory than existing boundaries, just as, in all the discussions of the greater sense inherent in dividing the country into "natural" region, rather than States, there has been no agreement on "natural" regional boundaries.

In recent years, Federal agencies have shown considerable ingenuity in achieving necessary areawide administration, while preserving the role of the general governments affected. Planning and other performance requirements under Federal grant and loan programs can go far toward achieving rational physical development projects, even in an area that is politically fragmented. Aids for functional and comprehensive planning have become legion in number if not in name.[3]

For certain functions nothing less than nation-wide planning will assure adequate performance. Thus, aid under the Federal Aid Airport Program is limited to projects which are part of the National Airport Plan. Similarly, each Federally aided construction project under the Interstate Highway Program must constitute an improvement in the Federally approved national highway system. For other functions, regions less than national but not necessarily confined to any existing political boundaries are preferable. All Federal water resource projects must be part of a comprehensive river basin plan. Assistance under the Public Works and Economic Development Act of 1965 is made not to individual communities but to "economic development districts" and "areas" experiencing substantial and persistent unemployment. Under the same act, joint Federal-State regional action planning commissions similar to the Appalachian Regional Commission are authorized in multi-State regions meeting certain economic criteria.

It is at the metropolitan level that the major administrative innovations have been developed, mainly in the last 5 years, to assure geographically adequate planning and development. In 1960, the term "metropolitan" could scarcely be found in Federal law or regulation. Today, most new grant-in-aid programs and more than one-third of

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[3] National Association of Counties, *Comprehensive Planning . . . Federal Assistance Programs* (Technical Advisory Report No. 2, Washington, D.C.). Lists some 20 different Federal agencies' programs of assistance for comprehensive planning, basic data collection, and transportation and public facilities planning.

the existing Federal programs affecting urban development encourage broader jurisdictions for areawide coordination of projects, in law, in official policy statements, and in definitions of eligible projects.[4]

The principle of geographically adequate development as a condition of Federal assistance is now the official policy of the Executive Branch, as indicated in the President's message on "Problems of the Central City and Its Suburbs."

A few of the more outstanding examples of this new element in Federal performance requirements follow. The Federal Highway Act required that, beginning July 1965, no funds can be approved for a project in any urban area of more than 50,000 population unless there is an established continuing comprehensive transportation planning process for the urban area as a whole. By December, 1965, it was reported that this transportation planning process was ". . . underway in all 224 urbanized areas of more than 50,000 population and in many smaller areas as well. In the majority the process is fully adequate to pemit evaluation of any proposed transportation system and in most of the remainder it can provide reasonable bases of review of individual projects. The fears of some that the planning requirement of the 1965 Act would serve to delay the Federal-aid highway program have proved unfounded."[5] Whether these planning operations will undermine or strengthen comprehensive metropolitan planning agencies remains to be seen; nevertheless, the 1965 requirement marked a milestone in intergovernmental affairs by linking local governments in the entire urbanized and urbanizing area with the State highway agency and by directly joining policy-making to implementation.

Under the open space land program of the Department of Housing and Urban Development, the Secretary is authorized to make grants only if he finds that there is a comprehensive planning program for the entire urban area, and that the land to be acquired for open space use is important to the execution of a comprehensive plan. The Urban Mass Transportation Act of 1964 carries language that is increasingly becoming boilerplate for legislative draftsmen. Grants can be made only to carry out a program "for a unified or officially coordinated urban transportation system as part of the comprehensively planned development of the urban area . . ."

Although less use has been made of incentives to achieve effective areawide administration, two recent examples, however, can be cited. The 1965 amendments to the Federal Water Pollution Control Act authorize an additional 10 percent grant for those sewage treatment construction grant projects that are certified by an official State, regional, or metropolitan planning agency as being in conformity with a comprehensive plan of development. The Economic Development Act authorizes the Secretary of Commerce to increase the amount of grant assistance by 10 percent if the redevelopment area is situated within a designated economic development district, is actively participating in the economic development activities of the district, and if the spe-

[4] Advisory Commission on Intergovernmental Relations, *Impact of Federal Urban Development Programs on Local Government Organization and Planning* (Washington, D.C.: Government Printing Office, 1964), p. 16.

[5] E. H. Holmes, "Progress and Events Since the First National Conference on Highways and Urban Development." Remarks at the Second National Conference on Highways and Urban Development, Williamsburg, Va., Dec. 12–16, 1965, p. 5.

cific project is consistent with an approved district economic development program.

The President, in his March "Cities" message, reaffirmed the new operating procedures in a proposal to establish a $100 million annual grant program for urban water and sewage facilities:

> The Federal Government cannot and should not require the communities which make up a metropolitan area to cooperate against their will in the solution of their problems. But we can offer incentives to metropolitan area planning and cooperation.

The incentive turns out to be a "condition of Federal assistance" that "these grants will be contingent upon comprehensive areawide planning" of the facilities to serve an entire region, taking into account foreseeable growth needs. Following enactment of this legislation in the first session of the 89th Congress (along with three other entirely new waste water control grant programs, bringing to six the number of water pollution control grant programs, each administered by a different Federal agency) the Department of Housing and Urban Development issued regulations governing eligibility for project grants. Four planning elements are required:

1. The project is consistent with a short-range areawide water or sewer system program;
2. The areawide program is based on long-range, areawide water and sewer planning;
3. Water and sewer planning is part of long-range, areawide comprehensive planning; and
4. Comprehensive planning is conceived and carried out to attain urban area goals and objectives under the policy direction of local elected officials.[6]

The approval is not limited to physical development activities. Illustrating what Humpty Dumpty meant when he said to Alice, "When I use a word it means just what I choose it to mean—neither more nor less," the new *Community Action Program Guide* issued under the Economic Opportunity Act, containing instructions for applicants, defines "community" as:

> . . . any urban or rural, or urban and rural, geographical area, including but not limited to a State, metropolitan area, county, city, town, multi-city unit, or multi-county units. Generally, a community should be coterminous with a major political jurisdiction such as a city or county, or with a group of political jurisdictions exercising responsibility for related public programs. In metropolitan areas, whenever feasible, the community should include all of the urbanized or urbanizing portions of the area.
>
> A community shall cover a geographical area of sufficient size and population to allow for the effective utilization of human physical and financial resources in an attack on poverty. Communities containing very small populations are encouraged to combine their efforts with adjacent jurisdictions to ensure the creation of an adequate resource base . . .

The States have made less use of planning requirements or incentives, but, rather, have tended to act as administering agents or have

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[6] Department of Housing and Urban Development, *Water and Sewer Facilities Planning Requirements: A Program Guide* (Washington, D.C.: Nov. 29, 1965), p. 1.

imposed standards and responsibilities on local governments in a manner politically and legally inappropriate for Federal agencies. The States have an increasingly substantial record of direct action in regional planning, provision of water, recreational facilities and open space, air and water pollution control, and, in the East, subsidies to regional mass transportation. In regional development, Connecticut took the lead in 1955; today, 15 regions have been defined, and seven regional planning agencies have been activated, covering 80 percent of the State's population. California regional planning legislation in 1963 automatically created regional planning districts when two-thirds of the local governments declare there is a need for such a district. New York State's Office of Regional Development has recommended the designation of development regions and the creation of regional councils to prepare comprehensive regional plans. Georgia has divided the State into 16 planning districts.

Some States have taken away or modified small local governments' zoning powers in the interests of more effective planning for a larger area, supporting a technical staff competent to provide continuing attention to development problems, and discouraging excessive fiscal zoning practices on the part of small municipalities. The State of Kentucky in 1964 removed the zoning power entirely from municipalities under 1,000 population. In Indiana a single Metropolitan Planning Commission and Board of Zoning Appeals has been established, and all local boards abolished in the Indianapolis-Marion County Metropolitan Area. The State of New York in 1960 provided for county review of local development actions of county-wide significance. Connecticut has provided for similar review of certain town zoning decisions by the regional planning agency.

These are promising beginnings, but hardly more, as indicated. Lest this review end on too "Pollyanna" a note, it may be appropriate to quote from a 1964 resolution of the National League of Cities:

> Certain Federal programs encourage undesirable sprawl by financing partial public facilities and urban housing which (1) do not take into account population trends; (2) are not required to meet adequate standards; (3) require or permit the creation of special districts that bypass general governments; or (4) are not part of a plan that takes into account how the particular program will affect the overall growth of the area. Among Federal agencies involved in these practices in the fields of public facilities and urban housing are: Farmers Home Administration, Community Facilities Administration, Federal Housing Administration, Veterans Administration, Area Redevelopment Administration and its Accelerated Public Works Programs, the Rural Areas Development Program of the Department of Agriculture and the General Services Administration's surplus real property disposal program.[7] Passage of the Resolution was followed by creation of a Joint Task Force on Substandard Urban Expansion supported by the League and the National Association of Counties.

As previously indicated, the majority of Federal-aid programs for urban development still do not encourage areawide jurisdiction over

[7] National League of Cities, *National Municipal Policy* (Washington, D.C., 1965), pp. 71–72.

the planning and administration of urban development programs, but accept whatever areas of jurisdiction (usually strictly local) the States and localities make available. Population limitations in such grant programs as rural electrification, public facility loans, and sewage treatment plants similarly tend to discourage areawide programs for planning and administration. A financial bonus for smallness of area covered is actually given in the urban renewal program to communities under 50,000 population in the form of three-fourths rather than two-thirds Federal matching grants.

Economies of Scale

References to economies of scale to be realized from performing urban services on a large scale are common in metropolitan reorganization literature, though significant research to date is limited.[8]

FEDERAL FUNCTIONAL PLANNING, JOINT PERFORMANCE, AND SPECIAL DISTRICTS

Most Federal aids in urban areas are for special types of facilities which are most effective when planned as systems. Planning a functional and systematic network of each type of facility, e.g., water supply, sewage disposal, transit, and even hospitals, is necessary to achieve economies of scale and avoid haphazard location of facilities.

From 43 Federal urban development programs examined,[9] these facts emerged: 15 Federal aid programs require conformance with official plans for the function being assisted; four require review only, not necessarily conformance; and 11 stipulate that aid projects be "not inconsistent" with existing functional plans. Programs requiring conformance to local or metropolitan-wide functional plans, in addition to those cited above having area-wide planning requirements, include such basic urban services as urban renewal, area redevelopment projects, advances for public works planning, and FHA mortgage insurance (only with regard to housing in urban renewal areas or for relocation of displaced families).

Federal programs in large metropolitan areas with inadequate functional planning requirements tend to be those of less significance for urban development and include public facility loans (limited to communities under 50,000), reclamation projects, and Agriculture loans to associations for water supply projects.

Nearly one-half of Federal urban development programs require some degree of State involvement. State supervision in many of these cases can be exercised to aid coordination across local political boundaries, if not between different types of aid. Thus, federally aided projects for hospital facilites, sewage treatment construction grants, and highways must conform to and be included in a State plan.

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[8] See Harvey E. Brazer, *City Expenditures in the United States* (New York: National Bureau of Economic Research, Inc., 1959), Advisory Commission on Intergovernmental Relations, *Performance of Urban Functions: Local and Areawide* (Washington, D.C.: Government Printing Office, 1963), and Werner Hirsch in *Public Expenditure Decisions in the Urban Community* (Washington, D.C.: Resources for the Future, Inc., 1963).

[9] Advisory Commission on Intergovernmental Relations, *Impact of Federal Urban Development Programs on Local Government Organization and Planning* (Washington, D.C.: Government Printing Office, 1964), p. 18.

Another way of promoting economies of scale is to authorize or encourage two or more governmental units eligible for Federal aid to participate jointly in a cooperative project. Specific legislative authority for this type of aid exists in about a quarter of the Federal programs and at least another quarter which administratively authorize joint projects. Thus, the Public Housing Administration deals with joint city-county and, in a few cases, multicounty housing agencies. In cases where single jurisdictions are too small to finance local staffs individually, joint housing authorities are being administratively encouraged. Ceilings of $1.2 million on grants for waste treatment works for individual projects are raised to $4.8 million when more than one community participates under the 1965 Water Quality Act.

Federal agencies have generally taken a pragmatic approach in establishing organization requirements for grant eligibility. In a recent Senate survey of grant programs, only one in four Federal aid officials felt that the involvement of special districts in the administration of their programs raised problems in coordinating their program with local governments and other Federal activities at the local level.[10] The primary Federal interest is to assure professional performance and achievement of specific program objectives, rather than strengthening the general purpose units of government, the cities and the counties. Most Federal aid is available to both general purpose and special units of local government. The special purpose units, generally endorsed, and required by about one-quarter of all Federal programs, ostensibly to achieve an appropriate workload and resultant economies of scale, include regional planning agencies, local area redevelopment organizations, industrial development authorities, rural area development committees, irrigation districts, and water user associations. The proposed Intergovernmental Cooperation Act contained in the President's Budget Message for 1966 includes a section granting general local governments priority over special districts in eligibility for Federal aids. In addition, where special districts do receive Federal grants, they would be required to provide full information concerning the request to the local governments in the area.

All of these approaches taken by the Federal Government, functional planning requirements and assistance, authorization and encouragement of joint performance by local governments, eligibility of special districts, increase the potentialities for achieving economies of scale in urban services.

THE STATES ACT IN THE NAME OF EFFICIENCY

The marked decline in independent school districts was the brightest finding of the 1962 Census of Governments, because consolidation resulted in economies of scale. Here the States have been most successful in rationalizing the performance of a basic governmental service, largely through offering the incentive of extra aid if school districts consolidated, but also through direct mandate. Credit should also be given to the political efforts of the teaching profession, which saw in

[10] U.S. Congress. Senate Committee on Government Operations, Subcommittee on Intergovernmental Relations, *The Federal System as Seen by Federal Aid Officials*, 89th Cong., first sess., p. 84.

consolidation a means of raising educational standards and, at the same time, getting a living wage.

Currently, States are acting to preserve existing economies of scale through control of new municipal incorporations. At least seven States have, in the last 2 years, established regulatory machinery, either in the form of a State agency, or, as in California, by creating a local agency formation and annexation commission in every county. One of the key elements in this kind of legislation is the statutory standards that review commissions must take into account including "the present cost and adequacy of governmental services and controls . . . and the probable effect of the proposed action and of alternative courses of action on the cost and adequacy of local governmental services and regulation in the area and in adjacent areas." [11]

A 1963 Georgia enactment, authorizing State financial incentives and technical assistance where political subdivisions establish joint undertakings, may serve as an example for other States. A very significant piece of State legislation enacted in 1965 is the joint resolution in Utah, proposing a new article of the State constitution authorizing creation of "metropolitan region governments." If adopted by the voters, this amendment will permit countywide metropolitan government to assume the powers and functions of existing cities and special districts in an area and to provide for the necessary revenue.

THE GREAT EQUALIZER

Government should be able to raise adequate revenue and do it equitably. "Some observers contend that public finance, not governmental structure, is the nub of the metropolitan problem. They argue that, given sufficient funds and equitable distribution, most of the difficulties, whether traffic, blight, or pollution, can be overcome without major changes in the existing governmental pattern." [12] The uneven allocation of fiscal resources at the differing levels of service among local governments in metropolitan areas is becoming exacerbated as central city and suburban populations, especially in our larger and older metropolitan areas, are becoming increasingly distributed along economic and racial lines. Here, in achieving financial equity, the Federal and State Governments have a crucial role to play.

As Alan Campbell has written: "National-State-local Federal fiscal interdependence is one of the major aspects of the interdependence of the entire system." [13] Federal and State aid form "the bridge between expenditure assignment and tax assignment. This function of aid demonstrates the interrelatedness of the total system and shows the crucial role played by intergovernmental flows of funds." [14]

Intrametropolitan redistribution of tax revenue has been limited to occasional use of sales and payroll taxes. The flow is essentially from the Federal and State Governments to the local governments. The direction of this flow recognizes the superior tax base and the mobility of people, industry, and, indeed, of problems throughout the Nation.

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[11] *California Government Code*, sec. 54786.

[12] John C. Bollens and Henry J. Schmandt, "*The Metropolis: Its People, Politics, and Economic Life*" (New York: Harper and Row, 1965), p. 340.

[13] Alan K. Campbell, "National-State-Local Systems of Government and Intergovernmental Aid," *The Annals*, May 1965, p. 95.

[14] *Ibid.*, p. 103.

Both Federal and State grant programs, especially since the thirties have given statutory recognition to underlying differences in relative local capacities to raise funds. The case for equalization provisions in grants-in-aid to governments in metropolitan areas is strong. Given the wide diversity in fiscal capacity among these local governments, more nearly uniform minimum program levels can best be obtained through equalizing grant provision. Both the Hoover Commission and the Kestnbaum Commission studies concluded that equalization provisions should be incorporated in grant programs.

Professors Cohen and Grodzins, as part of a larger study documenting the essential consistency that marks the economic impacts of Federal and State-local governments concluded that, while Federal taxes were found to have a greater redistribution effect than State-local taxes, the State-local tax system, despite its dependence on the property tax, had an equalizing effect of its own. On the other hand, State-local expenditures had a greater redistribution effect than Federal expenditures. "Considering taxes and benefits together, both levels of government redistribute income in the direction of greater equality, the Federal Government more so than the State-local governments * * * Equalization of income is assumed to be a desirable fiscal policy. Sharing passes the [consistency] test because both governments together transfer income from higher to lower income groups." [15]

Federal and State equalization among the many local governments in any given metropolitan area takes three basic forms: (1) use of allocation and matching formulas in grants; (2) use of a progressive system of tax collection; and (3) the program purposes to which the tax funds are put.

INTERGOVERNMENTAL FISCAL AID

Most Federal grant programs and some State programs have two distinct but related provisions which determine how much each State or local government will get. First is the so-called allocation or apportionment formula which relates to the manner in which the Federal appropriation is apportioned among the State and local recipient governments. The typical newer Federal grant program takes into account program need as measured by the total population or by some other index, such as incidence of disease, plus an index of financial need, to. assure that poorer jurisdiction will get more funds. State grants for education tend to be inversely related to property value and directly related to number of students or population of school age. Welfare aid is related to the number of welfare eligibles.

The other provision pertains to the matching funds required to be raised by State and local governments as their share of aided program costs. The Federal Government has generally adopted personal income in each State as an index of relative matching capacity. States have tended to rely on the equalized value of taxable property for their index of capacity.

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[15] Jabob Cohen and Morton Grodzins, "How Much Economic Sharing in American Federalism?" *The American Political Science Review*, March 1963, p. 19.

There has been a discernible trend in recent years for the Federal Government to pay a larger part to total project costs, e.g., the 90–10 highway program (half the funds are spent in metropolitan areas) and urban renewal, or a larger share of the cost of minimum payments, as in public assistance. Project and demonstration grants also have a greater equalizing effect in that they tend to be directed to communities and individuals in the greatest need. These approaches minimize the importance of the matching provisions. Some States where general assistance is locally financed have emergency State aid programs for areas in greatest need. Certain new Federal programs, such as the Economic Opportunity Act, and the Education, Appalachia, and Economic Development Programs go primarily to the poorest jurisdictions for support of a range of local programs.

Preliminary findings in a Brookings-supported study of intergovernmental systems and fiscal patterns in metropolitan areas being conducted by Alan Campbell and Seymour Sacks, add to our understanding of the complex world of State-local fiscal and functional relationships. State aid, and likewise Federal aid, is found on the whole to be additive to local tax efforts. In metropolitan portions of States, however, State aid today is only two-thirds as high as it is in nonmetropolitan communities. The nature of the State aid pattern, of course, varies considerably by State, depending on the pattern of political power in State legislatures.

With more than half the States now having completed reapportionment on the basis of population, and the rest in process of following suit, additional aid can be anticipated, especially for the currently underrepresented suburban areas. As suburban jurisdictions ringing central cities grow older, it will be hard, both politically and administratively, to separate suburban from city interests. The end result is likely to be a redirection of the present rural orientation of State aids into metropolitan areas.

TAX, TAX, TAX

Equalization in financing of local government services is also achieved through Federal and State tax systems. The use of Federal and State personal and corporate income taxes to finance grants-in-aid produces considerable equalization through application of uniform and progressive national and State tax rates. The Federal and State Governments collect the great bulk of all taxes in the United States today, 83 percent (65 percent Federal; and 18 percent, State); 17 percent is collected by local governments. In 1963, Federal and State tax revenues represented 23 percent of national income, while local tax revenues totaled only 4.6 percent.[16] This is all the more significant with respect to the ability of governments to raise revenues and raise them equitably, when it is realized that local governments rely almost exclusively on the property tax which is not so carefully geared either to ability to pay taxes or to benefits derived from governmental programs. The long-range trend in governmental finance has been toward a sustained growth in the size of State payments to local governments, with a consequent property tax relief and additions to State taxes.[17]

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[16] Campbell, *op. cit.*, p. 99.
[17] Federation of Tax Administrators, *Tax Administrators News*, vol. 29, No. 4, April 1965, p. 1.

At the interstate metropolitan area level, Robert Dixon [18] has advocated creation of Federal-interstate agencies to meet mass transit, air pollution, land use planning, and water resources needs. To break the pattern of limited use of the interstate compact as "low level devices for low level patterns," he advocates a levy of special taxes within the interstate metropolitan level for use solely within the region. Professor Dixon argues that the Constitution's uniformity clause applies only to general Federal tax levies which must be used to support Federal activities throughout the United States, and is no constitutional barrier to a Federal area tax to support area projects.

The notable current issue in Federal-State-local fiscal relations is the Heller plan to turn over almost unconditionally to the States about $2.5 billion in Federal tax revenues each year. National expenditures have increased in the last decade by some 25 percent, while State and local expenditures expanded approximately five times as fast. At the same time, a growing economy is bringing in increased billions each year in Federal revenues.

The Nation's Governors asked that the President give it fresh consideration. Many mayors, and organized labor in general, are against the plan because they fear little money channeled through States would get to the cities. A politically acceptable approach has not yet been worked out, but would likely involve an increase in the equalization effects, through apportionment formulas or "earmarked" grants to meet specific urban needs, or both.

SPEND, SPEND, SPEND

The purposes to which grant funds are put probably have the greatest equalizing effect of all. Increasing Federal and State aids for such programs as economic opportunity, depressed areas assistance, urban renewal, low and moderate income housing, medicare, mass transit, water supply, sewage disposal and sanitation, and education all indicate a shift of Federal and State interest from rural to urban concerns, and to human as well as physical needs.

The latest *Catalog of Federal Aids to State and Local Governments* [19] identified 115 programs of national aid containing 216 separate authorizations. Some 17 major new grant programs were initiated in the 88th Congress. Both the number of grants and dollar amounts involved were exceeded in the first session of the 89th Congress by the enactment of 17 major new grant programs and the expansion of a number of others, led by a one and a half billion dollar enactment for elementary and secondary schools which the President described as "the most significant step of this century to provide widespread help to all of America's school children." Other new grants dealing even more specifically with metropolitanwide problems include the Public Works and Economic Development Act, grants for basic water and sewer facilities, grants for advance acquisition for land, river basin planning, land development insurance, the Water Quality Act, solid

[18] Robert G. Dixon, Jr., "Constitutional Bases for Regionalism: Centralization: Interstate Compacts; Federal Regional Taxation," *The George Washington Law Review*, October 1964, pp. 47–88.

[19] U.S. Senate, Subcommittee on Intergovernmental Relations of the Committee on Government Operations. *Catalog of Federal Aids to State and Local Governments* [Supplement January 1965] (Washington, D.C.: Government Printing Office, 1965).

waste disposal, highway beautification, and even a grant (89-344) for "reimbursement to States and localities for sidewalk repair."

No one of the equalization arrangements in Federal and State aid, allocation and matching formulas, use of progressive tax systems, program purposes achieves great equalization. The cumulative effect, however, is substantial.

Local Government Responsibility

The decentralized character of American political party organization and the district system of election for the U.S. House, and for many State legislatures assure both protection against Federal and State domination and solicitous concern for the fate of local jurisdictions.

The main ingredient in the marble cake of American federalism is the grant-in-aid which acknowledges the superior ability of local governments to minister to the service needs of their residents. Federal and State aids and local "home rule" provisions in State constitutions and statutes rest upon an acceptance of city and country responsibility for the whole range of urban services. Although grants are available to special districts as well as to general purpose jurisdictions, the great bulk of local expenditures are made by the general governments. Of all direct local governmental expenditures in 1964, municipalities account for 33 percent, counties 20 percent, townships 4 percent, school districts 38 percent, and all special districts only 5 percent.[20]

Even for Federal grants administered on a regional basis, Federal agency guides and requirements have emphasized the importance of adequate representation of and consultation with local officials. Two recent examples, in addition to the highway and water and sewer facilities grant requirements referred to above should be cited. The Department of Housing and Urban Development, in awarding "701" metropolitan planning assistance grants, must be satisfied that all parts of the region are adequately represented on the planning body. The planning agency must establish a "checkpoint" procedure for review of recommendations on preliminary drafts of planning proposals by the chief executive and legislative body of the localities in the planning area and by other affected local, State, and Federal agencies. In addition, working with councils made up of elected officials in the metropolitan area is recommended as desirable practice. This has been facilitated by new authority under the Housing and Urban Development Act of 1965 (89-117) for the Secretary to make available two-thirds matching grants to support the activities of such councils, including studies of common legal, governmental, and administrative problems in the area. The Economic Development Act requires the Secretary of Commerce, before making grants to an economic development district, to give local general government officials "a reasonable opportunity to review and comment upon proposed projects." The Secretary is also directed to "encourage participation by appropriate local governmental authorities in" the designation of such districts.

Many Federal programs, including urban renewal and public housing, require creation of citizens' advisory groups to insure participa-

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[20] U.S. Bureau of the Census, *Governmental Finances in 1963-64* (Washington, D.C.: Government Printing Office, 1965).

tion by local residents. The new Economic Opportunity program has gone so far in requiring participation by the poor in the development and administration of programs that many mayors complain that their responsibility as elected officials is being undermined.

Toward a Strategy for Metropolitan Areas

The foregoing has been a review of Federal and State efforts in recent years to adapt policies and programs into what Henry Hart has called a more discriminating form of cooperative federalism [21] to meet the needs of government in metropolitan areas. What is in order now is to develop and pursue a more consistent Federal and State strategy to achieve the objectives of geographic adequacy, economies of scale, adequate and equitable financing, and strengthened responsibility and accountability of local general governments in metropolitan areas.

National and State activities should occur in the form of a comprehensive reform effort, and as individual opportunities present themselves. A reform effort for metropolitan areas should include a number of basic policies:

Comprehensive and functional planning requirements should be applied in all Federal and State aid programs significantly affecting urban development, and incentives provided for joint participation by local governments in programs lending themselves to areawide administration.

The States should give local governments in metropolitan areas tools to control the use of special districts, including requiring approval by the local general government of land acquisition by special districts; making local approval a condition precedent to the creation of special districts; setting various standards for local governments; and providing for their dissolution if the governments in the area are willing to take over responsibility for the special district function.

The States should establish strict statutory standards for new incorporations within metropolitan areas. States should also review financial aid arrangements, to eliminate provisions which encourage local government proliferation or subsidize otherwise unviable local governments.

More determined use should be made of State regulatory powers and performance standards in such fields as urban water supply and sewage treatment to ensure orderly and economic urban fringe development consistent with comprehensive land use goals.

Federal formula grant programs to State and local governments should take into account relative disparities in fiscal capacities and needs among local governments in metropolitan areas, and should aim at a reasonably uniform level of program performance throughout the country.

States should revise their grant distribution formulas to equalize local property taxloads among local jurisdictions in metro-

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[21] Henry C. Hart, "The Dawn of a Community-Defining Federalism," *The Annals*, May 1965, p. 149.

politan areas, and should finance at least half of the cost of programs which meet needs least likely to be directly related to the availability of public resources, such as general public welfare assistance and special programs of public education. States should also pay part of the non-Federal share of such essentially Federal-local programs as urban planning, urban renewal, low income housing, airport development, hospitals, sewage treatment and public water and sewer facilities, mass transit, and regional planning.

Because of the crucial role in State-local fiscal relations played by education, each State should make a critical review of its present school grant formula to insure that it provides for a minimum educational level below which no community falls, and that it contains factors designed to measure as accurately as possible local tax effort and diverse community educational requirements (e.g., taking into account higher per pupil costs in urban slum areas.)

State enabling legislation for establishing metropolitan planning agencies should be reviewed to insure a dominant role for the elected officials of the area, including assurance of adequate representation of central cities in such bodies. State legislation should authorize creation of councils of elected officials with responsibility for administering the metropolitan planning program, including the Federally required continuing comprehensive transportation process.

Finally, the general-purpose governments of the Nation—cities, counties, and, in New England, towns—should be granted priority in the receipt of Federal and State grants for urban development or assistance, with special districts eligible only when local governments, singly or jointly, cannot or will not do the job.

It may be argued that the strategies proposed here will perpetuate, by patching up, the present system of overlapping and fragmentation. It can equally be argued that performance requirements in Federal and State aids, incentives to joint action, greater equalization in financial arrangements, and strengthening of general government responsiblities, can (through precedent and penalties for autonomy) work toward reducing barriers to more general governmental reorganization.

The strategy outlined is only half the battle for furthering the objectives stated above. The other half includes the whole range of horizontal interlocal devices, from liberalized annexation to review of local zoning, to Dade County-type federation and to Nashville-Davidson County consolidation. Many of the proposals made, however, would have relevance even if areawide governments were established throughout the United States.

The specifics of how to adapt existing programs along the lines recommended are well known. Precedents have been established in individual Federal programs, by individual States, and by local governments in metropolitan areas. Extensive hearings have been held on major aspects of this subject; e.g., comprehensive local and metropolitan planning requirements; favoring the eligibility for Federal aids of units of general local government—cities, towns, and counties—in con-

trast to special purpose districts and authorities; requiring advance notice on acquisition, change of use, and disposition of land. Model State bills are available.[22] New proposals are being made for the development of common areawide planing requirements to be used by all Federal agencies in a metropolitan area and for greater consistency in regional office boundaries. At least seven States have now created State offices of local affairs concerned with proposed and existing legislation affecting the structure and financing of local governments, coordinating State activities in urban areas, and encouraging joint action among local governments in solving common problems.

A crucial Federal role is increasingly being played—and has promise of being played even more effectively—as programs are focused on problem parts of the metropolitan area and as fiscal policies recognize the changing demands on State and local tax systems. Spurred by increasing urbanization, rapid reapportionment, the competition and stimulus of Federal activities, and better understanding of how to deal with urban problems, States are likely to play a more and more significant role of oversight and assistance to their urban areas. The most dynamic Governors today are those—both Republicans and Democrats—who are leading the fight in their States for urban oriented programs to meet broad metropolitan area problems, serving not only Democratic central cities but Republican suburbs as well.

The prospects look better than ever for treating Federal and State activities as part of a unity in achieving commonly accepted objectives for government in metropolitan areas. This will involve a major role in metropolitan areas for Federal and State Governments—a role that is likely to be good politics, and good administration, for a long time to come.

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[22] See hearings before the Subcommittee on Intergovernmental Relations, Committee on Government Operations, U.S. Senate, on S. 561, "The Proposed Intergovernmental Cooperation Act of 1965," 89th Congress, first session, and recent annual issues of *Suggested State Legislation,* Committee of State Officials on Suggested State Legislation. The Council of State Governments.

FEDERAL REVENUE SHARING WITH LOCAL GOVERNMENTS*

BY TEMPO—CENTER FOR ADVANCED STUDIES, GENERAL ELECTRIC COMPANY

INTRODUCTION

The Nation's cities face a staggering $262 billion revenue gap over the next 10 years—$125 billion of which can only be closed by the Federal Government.

The needs of the cities can be met without any increase in Federal tax rates, provided the Federal revenue return is accomplished through direct unassigned grants to the cities on the basis of their fiscal needs and capacities.

There has been a great deal of discussion of tax-sharing proposals over the past several years. Unfortunately, most of this discussion has been in terms of generalities, unsupported by hard data. The Executive Committee of the National League of Cities, therefore, ordered an objective economic study of the whole question by TEMPO, General Electric Co.'s Center for Advanced Studies.

This study calls for a gradual closing of the local revenue gap by allocating $1 billion of Federal funds to the municipalities the first year, rising during the following 9 years until, in the 10th year, the Federal allocation would be $26 billion.

The study also points out that since the $125 billion return of Federal revenues to the cities represents only 40 percent of projected increases in Federal tax revenues for the next decade at *present tax rates*, sufficient funds would be left over for expanding Federal programs as well as defense needs, raising the level of existing grant-in-aid programs, rebating funds to the States for education and other State-supported services.

BACKGROUND

A secret proposal to President Johnson by the President's Task Force on Intergovernmental Fiscal Cooperation in the fall of 1964 recommended that an amount equal to 1 or 2 percent of the Federal income tax base be distributed among the States for general government purposes, no strings attached. Press reports of this idea, now known as the Heller-Pechman plan, prompted the Executive Committee of the National League of Cities on December 2, 1964, to direct that a communication be addressd to the President of the United States, expressing the sense of the committee as follows:

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* A review of a special study for the National League of Cities, conducted by TEMPO—General Electric Co.'s Center for Advanced Studies.

1. The distribution of unrestricted Federal block grants to the States would compound existing inequities within the States in the allocation of financial resources as between the State and local governments for the operation of municipal government services for the urban population;

2. If such Federal assistance is to be given, it should be either (*a*) in the form of unrestricted block grants direct to incorporated municipal governments for such general purposes as may be determined by the officials duly elected by the people of each community to establish local policies, or (*b*) earmarked for municipalities as top priority in any restrictions imposed on block grants to the States, to be used as supplements to any or all other money available to municipalities from the States.

In his letter transmitting this expresssion to the President, January 8, 1965, NLC's President Henry W. Maier, mayor of Milwaukee, recited the acceleration of pressures on local governments to provide increased services and facilities for a rapidly increasing urban population, requiring massive additional public investments at the local level in addition to those already accumulated, and pointed out the indifference of States to urban problems as indicated by an actual decline of the percentage of State funds distributed to municipal governments.

"A program of unrestricted grants to the States would, in our view, compound these existing inequities," President Maier said. "It would most certainly allow an extremely uneven approach to our most pressing domestic problem—urbanization."

Delegates representing some 14,000 municipalities at NLC's 1965 Congress of Cities in Detroit made the above-quoted resolution of the Executive Committee official national municipal policy by unanimously endorsing it. At the 1966 Congress of Cities in Las Vegas, delegates unanimously approved the following addition to this statement of policy:

> Because the Nation's cities are in need of funds for the performance of existing services, expanding programs, and new services demanded by their citizens, the unrestricted block grant concept proposed above should be adopted, within the framework of an equitable formula for sharing funds among the Nation's cities.

In proposing this latter statement, the NLC Committee on Revenue and Finance recommended that such an "equitable formula" should be developed by NLC's staff, in cooperation with other State and professional associations and governmental officials.

Meanwhile, the 1965 National Governors' Conference was held in Minneapolis at the same time as the Congress of Cities was taking place in Detroit, and the Nation's Governors unanimously endorsed the concept of unrestricted block grants to the States. They appointed a committee to pursue the matter, with Gov. George Romney of Michigan as chairman and Gov. Pat Brown of California as vice chairman, Unofficial approaches were made by this group to the NLC Executive Committee suggesting that the two groups get together in an attempt to arrive at a mutually acceptable joint program to present to the U.S.

Congress and the President. But the NLC Executive Committee decided that they first needed additional facts upon which to base a position, and they directed the NLC staff to retain the services of economists to assist with the development of an analysis of the fiscal needs of local government in relation to the needs of State and Federal Governments. A position on the utilization of Federal grant programs, whether unrestricted or on a program basis, would then be based on this analysis and used by the National League of Cities and its membership in their efforts to expand, modify, or improve Federal and State grant programs as they relate to urban problems. The NLC further urged the four mayor members of the Advisory Commission on Intergovernmental Relations to have the ACIR study the fiscal needs of local government in relation to the needs of the State and Federal Governments, as a result of which the ACIR is now engaged in an ambitious study entitled "Fiscal Balance in the American Federal System," expected to be published in the summer of 1967.

Following its mandate to engage the services of economists, the NLC staff in the summer of 1966 made an agreement with TEMPO, the Center for Advanced Studies of the General Electric Co., at Santa Barbara, Calif. Although the first draft of this TEMPO report was submitted for review in late October 1966, it was considerably revised following publication in December 1966 of two volumes by the Joint Economic Committee, Congress of the United States, "*State and Local Facility Needs and Financing*." Also taken into account in the revised paper was a study by the Tax Foundation, Inc., "*Fiscal Outlook for State and Local Government to 1975*."

The TEMPO study was published in January 1967 under the title "*Options for Meeting the Revenue Needs of City Governments*."

Analysis of TEMPO Report

A. Revenue Gap

The TEMPO estimates of *total* local government needs for the decade 1966–75 have been based on the projected *capital* outlays for public facilities of local governments, which, in turn, were based on studies made by more than 40 independent experts for the Joint Economic Committee of the U.S. Congress. The estimates combine data for all local government units, including cities, counties, special districts, and school districts.

The *total* expenditures of local governments in the next 10 years are estimated at $975 billion, which, of course, are their revenue needs. To this is added a minimum estimate of $50 billion needed to replace dilapidated and overcrowded dwellings in urban slums, bringing total local government revenue needs, both for capital and operating purposes, to $1,025 billion.

Without any growth in local government revenues from present sources as a corollary of the growth of the national economy, the total revenues of local governments in 10 years would be $530 billion (based on actual 1965 revenues of $53 billion). Subtracting this from the $1,025 billion estimated needs would leave a revenue gap of $495 billion. However, the growth of the national economy at an annual

rate of 4 percent and the growth of State and Federal aid to local governments at an annual rate of 7 percent under present aid formulas would result in a cumulative growth in local revenues, including intergovernmental aid, of $233 billion during the period. This would bring the revenue gap down to $262 billion.

B. ALTERNATIVE FUNDING SOURCES

Potential means for obtaining the additional $262 billion needed by local governments over and above their present revenues and those expected to be generated through normal growth are analyzed in the TEMPO report.

1. *Increasing local property tax rates* only aggravates the problems of high-tax cities, is regressive and discriminatory, decreases returns on private investments, impels outmovements of middle and upper income families and business enterprises, causes deterioration of living and working conditions and erosion of the tax base, which in turn cause all manner of community problems. No part of the revenue gap should be attempted by increasing property tax rates.
2. *Increasing local taxes on sales and incomes* results in the burdens falling more heavily in some cities than in neighboring localities. As with property taxes, the effect of high local taxes is to impel people and business to move to avoid them, and the same results are to be expected.
3. *Increasing nontax fees and charges* selectively can help to bridge the revenue gap that cities face. The upper limit which can be expected from such increases is probably about 20 percent over the next 10 years, or a total cumulative increase of about $25 billion.
4. *Increasing local bonded debt* can finance $63 billion of the needed additional capital outlays.
5. *Increasing State aid to local governments* by 50 percent in the 10-year period ahead would provide $49 billion of the revenue gap.
6. *Increasing Federal appropriations to local governments* by $125 billion cumulative total over the next 10 years is necessary to close the residual amount of the revenue gap. This is feasible without raising Federal tax rates, because it is only 40 percent of the expected increment in Federal revenues over the next 10 years.

Table I.—Summary of funding sources

	Billions
Increases in local nontax charges	$25
Increases in local debt	63
Increases in State aid	49
Increases in Federal aid	125
Total	262

The Federal Share

It is important to understand why it appears possible for the Federal Government to raise a substantial part, if not all, of the total $262 billion projected local government deficit without increasing Federal tax rates. This is because tax collections tend to rise relatively sharply

as a result of economic growth. Under present Federal tax rates we can expect 20 cents in Federal tax revenues for each $1 increase in the gross national product. This means that if GNP grows by 4 percent per year, Federal tax revenues will be $32 billion greater in 1970 than in 1965, $62 billion greater in 1974, and $72 billion greater in 1975. Cumulatively, during the next 10 years, the increase would be $365 billion.

The $125 billion of increased Federal aid needed to meet the needs of local government in the next 10 years is in addition to the Federal aids which are now provided. Assuming present formulas and programs of Federal aid committed to States and local governments are continued, it is probable that the total cumulative increase in these ongoing aid programs during the next 10 years will amount to $60 billion (this was included in the $233 billion cumulative growth in local revenues, including local government aid, estimated above).

If $60 billion of the $365 billion cumulative increase in Federal revenue is presently committed to States and cities on the basis of trends in present Federal grants-in-aid programs, then $305 billion of the projected cumulative increase in Federal revenues during the next 10 years is, in fact, available. It is available for expanding defense spending, cutting Federal tax rates, increasing Federal assistance to local governments above present trends, etc. We repeat that the $125 billion required to close the revenue gap is an amount equal to only 40 percent of the uncommitted estimated incremental Federal tax revenues in the next 10 years.

A year-by-year summary of the estimated local government gaps for the 1966–75 period and the funding sources recommended in the TEMPO report is given in table II.

TABLE II.—*Estimated annual revenue gaps and recommended funding sources for the 1966–75 period*

[In billions]

Year	Estimated gap	Funding sources			
		Federal Government	States	Increases in local charges	Increases in local debt
1966	$4.5	$1.0		$0.5	$3.0
1967	8.0	3.0	$1.0	1.0	3.0
1968	12.0	6.0	2.0	1.0	3.0
1969	16.5	8.0	3.0	1.5	4.0
1970	22.0	10.0	4.0	2.0	6.0
1971	28.5	13.0	5.0	2.5	8.0
1972	34.5	16.0	6.0	3.5	9.0
1973	40.0	19.0	8.0	4.0	9.0
1974	45.5	23.0	9.0	4.5	9.0
1975	50.5	26.0	11.0	4.5	9.0
Total	262.0	125.0	49.0	25.0	63.0

C. OPTIONS FOR ROUTING FEDERAL FUNDS TO LOCALITIES

The TEMPO report devotes its final section to a discussion of different possibilities for administering Federal funds made available to local governments. One method is to route Federal funds through the States. But the study points out that—

> there are compelling reasons for not allowing the States to administer or even to decide how to allocate Federal funds intended to aid localities * * * Federal aid can be routed to cities in accordance with their relative fiscal needs and capacities without violating traditional Federal and State roles * * * Using the States as a conduit is justified only if the States add value to the services being supplied.

"The development of an allocation formula requires the selection of appropriate factors to define the relative fiscal needs and capacities of the Nation's cities, and then the assignment of appropriate weights to those factors," TEMPO added.

Other studies on the subject show that a straight per capita distribution of Federal revenues will not meet the criteria of placing the money where needed, and suggest per capita grants varying upward with increasing sizes of cities in recognition of the greater range of services and higher costs per capita of city governments as they increase in size. A special NLC committee stated in Washington, D.C., March 13, 1967, that this idea has merit, but should be combined with the assignment of weight to additional factors of need, such as unemployment, population density, nonresident influx, percentage of charitable and governmental properties excluded from the tax rolls, etc.

OPTIONS FOR MEETING THE REVENUE NEEDS OF CITY GOVERNMENTS*

BY ROBERT E. WEINTRAUB

INTRODUCTION

U.S. cities are currently confronted by complex problems that threaten to undermine their future usefulness as viable socioeconomic entities. Among the most pressing problems are spreading slums; intensification of education and health problems (and, as a corollary, hopelessness and hostility, especially among nonwhites); increasing crime rates; increasing traffic congestion; and increasing air and water pollution. These problems derive primarily from rapid environmental and population changes during recent decades.

Members of the National League of Cities are acutely aware of these problems as they manifest themselves in their individual cities. They understand the drain such problems are making on the resources of their city, but have not had an overview of the total resource implications for the nation to guide them in establishing league policy and taking league action. The Executive Committee of the league authorized a study which would determine the aggregate revenue requirements of city governments in the coming decade, assess their ability to raise these revenues through current methods, and explore the costs and benefits of using alternative revenue sources. The study was undertaken by TEMPO in the fall of 1966; this paper presents the results.

SUMMARY

U.S. cities are currently confronted by complex problems that threaten to undermine their future usefulness as viable socioeconomic entities. Cities[1] will be unable to cope with these problems without massive increases in revenues.

THE REVENUE GAP

Examination of major categories of city government need indicates that over the next 10 years total expenditures of $1,025 billion will be required. The 1965 income of city government systems ($53 billion) indicates a base of $530 billion for the coming decade with an additional $233 billion produced by normal growth. This leaves, therefore, a revenue gap of $262 billion.

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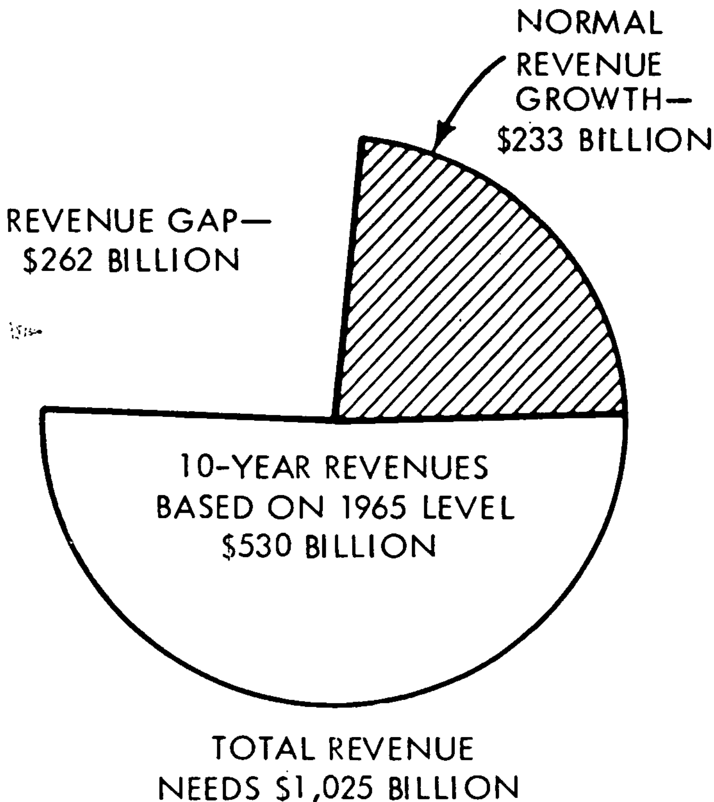
*Prepared for National League of Cities by TEMPO, General Electric Co., Santa Barbara, Calif., January 1967.

[1] The term "city" refers to those government systems which provide diverse public facilities and services in urban communities; the systems may consist of only single municipal governments or they may include municipal and county governments as well as school and special districts.

FUNDING SOURCES

Analysis of revenue-raising possibilities for city governments indicates that they have the least potential for increasing taxes equitably and the greatest potential for tax-induced inefficiencies in national resource allocation. States show increased potential over localities while the Federal Government has the greatest potential for raising revenues equitably and efficiently.



Revenue sources and requirements for city governments, next decade.

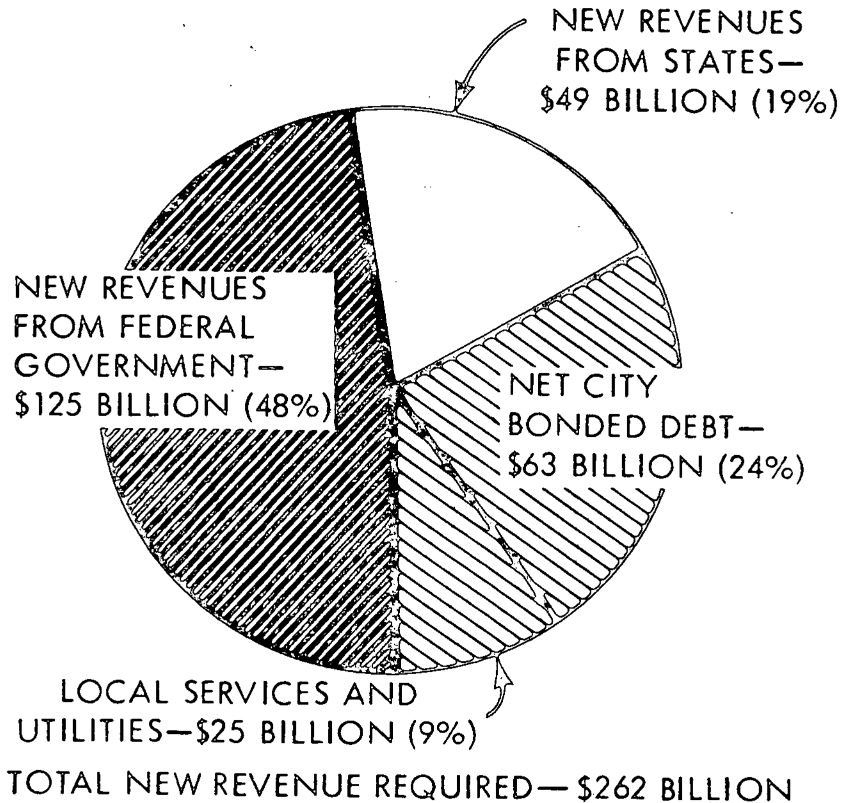
City governments have little potential for equitable and efficient taxation because (1) they must rely heavily on property taxes, which are regressive, and (2) differential tax increases of any type among localities will tend to cause investors and income-earning population to shift from high- to low-tax localities. The flow of incremental or new investment funds especially is likely to be sensitive to differences in intercity tax rates. This movement of resources becomes aggravated when revenues raised by additional local taxes are employed to solve today's pressing urban problems because the least productive elements

of a city's population are benefited more immediately than the investing and property owning public.

Such resource shifts have effects which reach beyond the localities involved; they result in inefficient allocations of resources and reduced productivity for the economy as a whole.

In view of these factors, the most promising and least disruptive sources of additional revenue at the city level appear to be increases in net city bonded debt and increases in charges for municipally supplied services and utilities; these could yield additional revenues of $63 billion and $25 billion, respectively, over the next decade without generating gross inequities and inefficiencies.

The arguments that apply to the undesirability of increases in city taxes also apply to States. Nevertheless, with their broader tax bases they can put together more acceptable tax packages than cities and because their revenue needs are rising less rapidly than those of the localities, State aid to cities could be increased by 50 percent in the next decade, providing $49 billion of the new revenue required by city governments.



Sources of new incremental city government revenues, next decade.

The Federal Government has the greatest potential for raising city government revenues without doing violence to the efficient allocation of resources. If the GNP grows at 4 percent per year, Federal tax revenues will rise cumulatively, over the next 10 years, by $365 billion. Of this sum, based on present trends in Federal aid, about $60 billion will go to States and cities. (The part which will go to cities is included in the $233 billion increase forecast for city revenues on the basis of present trends.) Assuming that there will be no major increase in the Nation's defense budget requirements, it appears feasible for the Federal Government to divert 40 percent, or $125 billion, of the remaining new revenues of $305 billion to city governments to close their revenue gaps while still meeting all other national expenditure commitments.

ADMINISTERING FEDERAL AID

Federal appropriations for cities can be made, essentially, in four different ways. These are—

1. Grants-in-aid for single-purpose specific projects.
2. Grants earmarked for some broad purpose such as education (i.e., "functional block" grants).
3. Grants for multipurpose projects.
4. Unassigned grants-in-aid.

Single-purpose grants-in-aid, which are usually made on a fund-matching basis and currently account for the bulk of Federal aid, are designed to achieve specific goals. But because there is a tendency for Federal specifications to become excessively detailed, they cause administrative difficulties and limit flexibility in innovation, adaptation to local situations, and integration of local programs. Further, since they are made on an ad hoc basis, the size of the grant frequently is not related to the relative fiscal needs and capacities of cities. Finally, because of the lure of fund matching, single-purpose specific grants can lead to city expenditures which are not in consonance with local requirements.

The use of "functional block" grants, multipurpose project grants, and unassigned grants by the Federal Government would result in increased local control of program and expenditures. Functional block grants permit spending to be tailored to local needs in broad problem areas. The derived benefit is the development of national priorities for city expenditure patterns with minimal interference with city program management. Multipurpose program grants-in-aid are commendable principally because they encourage program integration and permit coordination of diverse activities of city governments. On the other hand, these grants, like single-purpose specific grants, definitely limit flexibility. Unassigned grants are particularly attractive because they minimize Federal administrative work, permit maximum local control of spending and program integration, and allow aid to be distributed on the basis of relative fiscal needs and capacities of individual cities.

Each of these four possible administrative procedures offers some advantages. The optimum course would appear to use the single-purpose grant whenever a specific problem has clear-cut priority; to use the functional block grant to encourage local work on broad prob-

lem areas of national priority; to use the multipurpose project grant to encourage cities to develop integrated solutions to their diverse problems in the fashion of the Demonstration Cities Act of 1966; and to allocate unassigned grants in order to allow city governments to deal flexibly and effectively with their unique sets of problems.

In theory each type of grant can be routed through the States. This would appear to be cumbersome when making single-purpose specific project grants. It would be much more practical in making unassigned grants, with the other two types of aid ranging somewhere between these extremes.

In practice, there has been little effort made by States to aid in solving problems unique to urban areas. Since the Federal Government has developed more familiarly with these kinds of problems it could specify the allocation to be made of any funds routed to cities through the States. Also, since routing Federal funds through the States involves administrative costs this procedure can be justified economically only if the States add value to the services being supplied.

SECTION 1: THE GAP BETWEEN REVENUE NEEDS AND EXPECTATIONS

Estimates of the annual and cumulative gaps between city government [2] revenue needs and expectations for the coming decade are developed in this section.

REVENUE NEEDS

The revenue needs of city governments for the 1966–75 period have been estimated from studies which were made by more than 40 independent experts for the Joint Economic Committee of the U.S. Congress (reference 1). The relevant data are presented in tables 1 and 2. As shown in table 1, assuming that the GNP grows at a conservative 4 percent per year, a rate which is nearly one-third less than the growth rate achieved in recent years, the public facility capital outlays of city governments will range between $169 and $201 billion in the 1966–75 period. As indicated in table 2, these capital outlays will average 19 percent of total local government expenditures in the next 10 years. Or, to put it another way, the average ratio of total annual spending to annual capital outlays will be 5.26 to 1 (obtained by dividing 100 percent by 19 percent). Thus for the 1966–75 period the total expenditures of cities will range between $890 and $1,060 billion (5.26 × $169 billion minimum and 5.26 × $201 billion maximum). Splitting the difference, city governments are estimated to have revenue needs of $975 billion in the next 10 years. (This assumes, of course, that the division of responsibility between cities and States for supplying public facilities and services in urban communities does not change in the coming decade.)

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[2] Throughout this report the term "city" is used in the generic sense, referring broadly to the government systems which administer public facilities and services in urban communities. Thus a city government may consist only of a municipality, or it may include municipal and county governments as well as school and special districts.

TABLE 1.—*Estimated public facility capital outlays of municipalities and other local public agencies* [1]

[In billions of dollars]

Facilities	State and city public agencies [2]	City public agencies [3]	
		Minimum	Maximum
Water and sewer facilities	56.5	47.2	53.4
Gas and electric facilities	12.8	9.4	9.4
Highways, roads and streets	125.7	32.8	32.8
Offstreet parking facilities	2.4	2.4	2.4
Urban mass transit facilities	7.6	7.6	7.6
Other transportation facilities, airports, etc	5.4	4.6	4.6
Public elementary and secondary schools	41.8	39.3	41.8
Other educational facilities, educational TV, etc	20.2	0.8	0.8
Community mental health centers	1.5	1.5	1.5
Health research facilities	1.9	1.7	1.9
Other health facilities, hospitals, etc	9.8		9.8
Urban outdoor recreation facilities	17.6	5.5	17.6
Other recreation and cultural facilities	17.4	12.4	12.4
Police and fire stations and other public buildings	[4] 7.3	4.1	5.1
Total outlays	327.7	169.4	201.0

[1] Assumes GNP annual growth rate of 4 percent.
[2] Reference 1, vol. I, table 2.
[3] Reference 1, vol. 1, pt. II. Breakdowns of required capital outlays by category between State and local governments are given at the ends of individual chapters on the categories of outlays.
[4] This estimate includes $1,000,000,000 for police stations which is not included in the source table. The source for this figure is reference 1, vol. I, p. 14.

TABLE 2.—*Capital outlays of city governments as a percentage of total local expenditure, 1955–65* [1]

Fiscal year:	*Capital outlay percentage* [2]
1955	25.9
1956	24.5
1957	24.3
1958	24.0
1959	23.2
1960	22.1
1961	21.9
1962	21.5
1963	20.7
1964	20.3
1965	21.0
Projected mean, 1966–75	19.0

[1] Source: Reference 1, vol. II, table 2.
[2] Excludes insurance trust amounts.

The above estimate, however, makes no allowance for replacing dilapidated and overcrowded dwellings in urban slums and renewing other city areas, especially business or downtown districts. Realism dictates that the task of financing replacement of below standard housing units be regarded as a government job. This is because prospective tenants are not likely to be able or willing to pay rents high enough to make private investment in replacing dilapidated dwellings in slum areas profitable. A minimum estimate of the revenue needed for this task is obtained by computing the cost of replacing the 5 million urban dwellings classified as dilapidated or overcrowded in the 1960 Census with units costing an average of $10,000 each or, conservatively, a total of $50 billion.

The $50 billion required to replace 5 million slum dwellings is only a fraction of the cost of overall urban renewal; no estimate is available on the total cost. Doubtless it is huge, but only that part which can be imputed to land acquisition and overall planning legitimately can be added to the revenue needs of cities. Regardless, our estimate of total revenue needs of U.S. cities in the coming decade is understated by this omission.

Adding the $50 billion estimated minimum cost of renewing dilapidated slum dwellings to the $975 billion revenues needed for other city government capital and operating purposes in the 1966–75 period, we obtain our final estimate of the total revenues needed in the 10-year period ahead to assure the continuing viability of U.S. cities—$1,025 billion.

In 1965 total revenues of city governments were $53 billion, excluding insurance trust amounts. Thus incremental city revenue needs for the 1966–75 period are $495 billion, derived by subtracting $530 billion (total 10-year income at the 1965 level) from $1,025 billion (total 10-year income needed).

EXPECTED GROWTH OF CITY REVENUES

A large part of the required $495 billion will be generated by the growth of city government revenues from present sources as a corollary of the growth of the national economy. Estimates of the growth of city revenues from present sources in the 10 years ahead are given in table 3.

If GNP grows by 4 percent per year, as was assumed in estimating the growth of city government revenue needs, then, projecting recent ratios of city revenue growth to GNP growth, revenues raised by city taxes and charges will grow at an annual rate of 6.3 percent and intergovernmental aid, i.e., State and Federal aid to city governments, will grow under present aid formulas and programs at 7 percent per year. Under these conditions, as shown in table 3, revenues raised locally during 1966–75 will increase by $161 billion and presently programed intergovernmental aid will increase by $72 billion. Thus the cumulative growth in city revenues will total $233 billion in the 1966–75 period.[3] Subtracting this sum from the estimated need of $495 billion a revenue gap of $262 billion is derived.

THE ANNUAL GAP

Estimates of annual revenue gaps facing U.S. cities in the fiscal period 1966–75 are given in table 4. The data show a steadily rising gap, increasing from $4.5 billion in 1965 to $22.2 billion in 1970 and reaching $50.3 billion in 1975.

[3] This estimate compares to one of $250 billion which is obtained on the assumption that all local revenues will grow at an annual rate of 7 percent during the next 10 years. The 7-percent rate is derived from a recent study by Dr. Elsie M. Watters. She estimated that all State and local revenues would rise by 98 percent between 1965 and 1975, or 7 percent on an annual basis. (See reference 2, table 3, p. 8.) The discrepancy between the two estimates can be explained by the fact that Dr. Watters projects a 172-percent rise in Federal grants-in-aid between 1966 and 1975, or 11 percent per year. This figure is high relative to the historical rate in relation to our assumption of a 4-percent-per-year increase in GNP. Also note that revenues from State sources are likely to grow faster than those from local sources.

TABLE 3.—*City revenues for 1965 and estimated revenues for fiscal 1966–75* [1]

[In billions of dollars]

Year	Level and cumulative growth of revenues from city sources		Level and cumulative growth in city government aid [2]	
	Level	Cumulative rise	Level	Cumulative rise
1965	$37.8		$15.2	
1966	40.2	$2.4	16.3	$1.1
1967	42.7	4.9	17.4	2.2
1968	45.4	7.6	18.6	3.4
1969	48.4	10.6	19.9	4.7
1970	51.5	13.7	21.3	6.1
1971	54.7	16.9	22.8	7.6
1972	58.1	20.3	24.4	8.2
1973	61.8	24.0	26.1	10.9
1974	65.7	27.9	27.9	12.7
1975	69.8	32.0	29.9	14.7
1966–75 total	538.3	160.5	224.6	71.6

[1] Assumes GNP annual growth rate of 4 percent.
[2] Assumes present formulas and programs of intergovernmental aid.

TABLE 4.—*Estimated annual gaps between city government revenue needs and expectations*

[In billions of dollars]

	(1) Expenditures	(2) Revenues from own sources	(3) Intergovernmental aid	(4) Revenue gaps (1)−[(2)+(3)]
Fiscal year:				
1966	$61.0	$40.2	$16.3	$4.5
1967	68.0	42.7	17.4	7.9
1968	76.0	45.4	18.6	12.0
1969	85.0	48.4	19.9	16.7
1970	95.0	51.5	21.3	22.2
1971	106.0	54.7	22.8	28.5
1972	117.0	58.1	24.4	34.5
1973	128.0	61.8	26.1	40.1
1974	139.0	65.7	27.9	45.4
1975	150.0	69.8	29.9	50.3
10-year total	1,025.0	538.3	224.6	262.1

SECTION 2: ALTERNATIVE FUNDING SOURCES

Over the next decade solutions to the problems that beset U.S. cities will require a total incremental expenditure of $262 billion in excess of present revenues and those expected to be generated through normal economic growth.

Table 5 gives a year-by-year summary of the estimated revenue gaps and recommended funding sources to fill them. The remainder of this section discusses the bases for the funding recommendations and potential means for obtaining the necessary revenues from the sources shown in the table.

TAXES AND OTHER CITY GOVERNMENT REVENUE SOURCES

The source and composition of city government revenues for 1965 are shown in the figure below. The most obvious way to augment city

TABLE 5.—*Estimated annual revenue gaps and recommended funding sources for the 1966–75 period*

[In billions of dollars]

Year	Estimated gap [1]	Funding sources			
		Federal Government	States	Increases in city charges	Increases in net city debt
1966	4.5	1		0.5	3
1967	8.0	3	1	1.0	3
1968	12.0	6	2	1.0	3
1969	16.5	8	3	1.5	4
1970	22.0	10	4	2.0	6
1971	28.5	13	5	2.5	8
1972	34.5	16	6	3.5	9
1973	40.0	19	8	4.0	9
1974	45.5	23	9	4.5	9
1975	50.5	26	11	4.5	9
Total	262.0	125	49	25.0	63

[1] Differences from gaps in table 4 are due to rounding.

revenues is to increase city tax rates and charges, including those set by special districts as well as those set by municipal and county governments. The benefits and costs of this approach are analyzed first.

Increasing Property Tax Rates

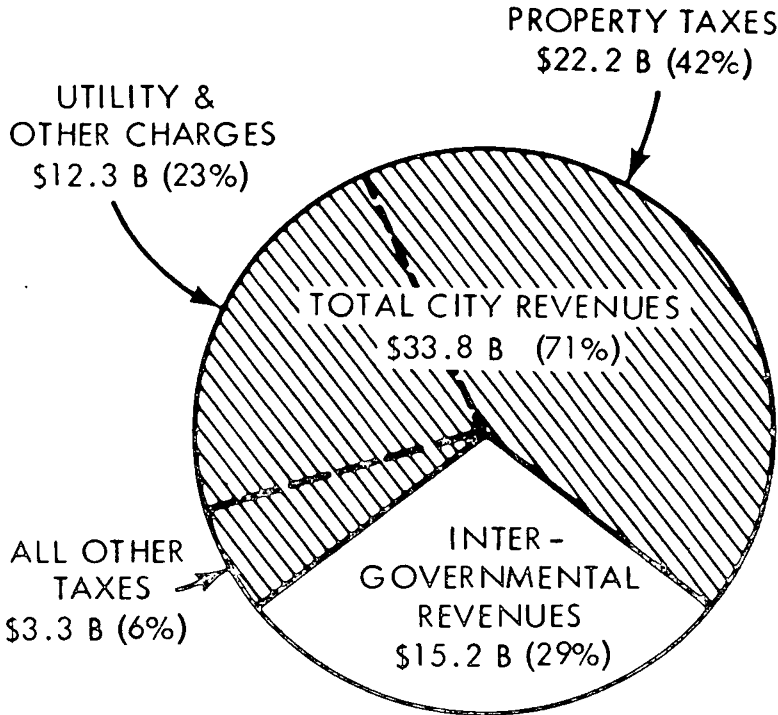
As shown in the figure, property taxes in 1965 comprised the largest single source of funding for local governments—$22.2 billion, or 42 percent of the total available funding. Manifestly, the revenues of city governments are far more sensitive to property tax rates than to other local tax rates and nontax charges. The power to collect additional revenues by merely raising property tax rates is a distinct advantage. In principle, this involves little administrative effort because properties must be assessed, disputed valuations adjudicated, and delinquent owners dealt with regardless of the tax rate per dollar of assessed valuation.

City property tax rates cannot be increased without administrative problems, however. Both tax delinquencies and appeals of assessments are likely to increase following a rate increase. Tracking down delinquents and adjudicating assessment appeals requires significant time and manpower. Thus, raising property tax rates is not a costless way of raising additional revenue.

Second, the accepted standard of justice in distributing the tax burden requires that equals be treated equally. Households with equal annual taxable incomes according to this criterion should be taxed equally. But different households, even though in the same income class, have widely different holdings of taxable property and the property tax is therefore discriminatory.

Moreover, available data indicate that the property tax is a regressive tax. For example, a study of the Detroit area indicates that the property tax collects 20 percent of the income of persons earning under $2,000 a year but only 1½ percent of the incomes of those earning over $20,000 a year.[4]

[4] From unpublished data compiled by the Survey Research Center, Institute for Social Research, University of Michigan in 1958–59. Cited in reference 3.



Sources of city government revenues—1965.

Third, differential increases in property tax rates directly change relative returns to investments in different locations. To illustrate the intercity link between property tax rates and investment returns suppose, other factors being equal, that property tax rates are increased in city "x" but not in "y." For homeowners in city "x" the effect is exactly the same as a rent increase. On taxable commercial property, the effect is to reduce the income stream from the property. In turn, this causes shifts in the pattern of investment activity and the distribution of population from city "x" to city "y."

Of course, programs financed by revenues from increased property tax rates may theoretically increase the attractiveness to investors and householders of investing and living in city "x" sufficiently to offset their objections to the tax increase. But in actuality there is no direct correspondence between property taxes paid and community services

received. To the extent that revenues raised by increased property taxes are used to solve today's most pressing urban problems—renewal of slums and improvements of the condition and abilities of slum dwellers—the net effect will be to impel outmovements of middle and upper income families and business enterprises, and inmovements of low-income groups with little capital or skills and a wide range of problems.

It is a demonstrated fact that this is precisely what has happened and continues to happen in many cities, especially core cities, throughout the Nation. It has occurred in Baltimore, Birmingham, Boston, Buffalo, Chicago, Cincinnati, Cleveland, Detroit, Kansas City, Los Angeles, Minneapolis, New York, Newark, Oakland, Philadelphia, Pittsburgh, San Francisco, and Washington, D.C., and also in Youngstown, Worcester, Toledo, Little Rock, and others. Also, because the size of the revenue gap differs from city to city, raising local property tax rates inevitably makes the cities with the gravest problems the ones with the highest taxes. The average age of buildings in these cities increases as new commercial and residential construction is drawn irresistably to relatively low tax cities. Accompanying this gradual aging of buildings in the higher tax cities is a gradual deterioration of working and living conditions, creating all manner of community problems ranging from increased sanitation problems to increased fire potential and a steady depreciation of their tax bases. Thus, high-tax cities are becoming increasingly powerless to finance their own expenditure requirements and simultaneously they are confronted by growing socioeconomic problems requiring public action.

From a national viewpoint, differential increases in property tax rates tend to offset natural site advantages and thereby distort the nationwide geographic pattern of industrial activity. The overall impact on the economy's operating efficiency is comparable to the impact of differential tariffs on the operating efficiency of the world economy. Differential tariffs result in deviations in the location of productive resources. Differential increases in property tax rates also cause deviations from the equilibrium pattern which emerges when investors decide where to locate productive facilities solely on the basis of natural economic factors.

Raising Other City Taxes

As shown on page 8, city governments currently collect relatively little revenue from general sales taxes, excises on selected goods, and personal and business income taxes. In 1965, total revenues from all such taxes were only $3.3 billion. Many believe that cities could substantially solve their revenue problems by increasing taxes on consumption and on personal and business income. This might be true if such taxes were levied uniformly throughout the Nation or at least over very wide areas. But because the financial problems of our cities are distributed unequally, it must be expected that taxes on sales and incomes will be increased more heavily in some cities than in neighboring localities. The benefits and costs of the development of an intercity tax structure marked by differential sales and income tax rates are discussed below.

The principal and perhaps sole benefit of increasing city sales, income, and other nonproperty tax rates in the cities that are confronted by revenue gap crises is that not only property owners, but all residents of these areas would share the burden of raising the required revenues. This is an important benefit for two reasons: first, it fulfills the tradition that everyone should help pay the costs of government; second, it is consistent with the precept of local responsibility for solving local problems.

The tax bases of sales and income taxes—i.e., taxable sales and taxable incomes—can be determined by the tax collector only at considerable expense. Thus, administration of such taxes at local levels involves greater expenditures per dollar collected than, for instance, dollars collected from increasing property taxes.

If sales and incomes are taxed in one city and nowhere else, and all other taxes are equal, then fewer persons will wish to shop, work, and live in that city. Again, the direct effect of high local taxes is to impel people and business to move to avoid these taxes.

The shifts in economic activity and population that accompany differential increases of local sales and income tax rates tend to decrease the national economy's operating efficiency. As with property taxes, this is because the shifts are responses to artificial stimuli, not natural economic factors.

The outmovement of activity and people from cities with high sales and income taxes reduces the demand for local land for both commercial and residential uses. This leads to lower land rents and lower prices of goods and services than in other cities. Because demand prices fall, total sales and incomes are reduced, decreasing the tax base. Thus, increases in local sales and income taxes very seldom produce as much revenue as predicated by advocates. More important, because rents fall, property values and thus property tax revenues fall when city sales and income taxes are raised. This indirect cost ordinarily is not considered, but occurs nonetheless.

The decrease in rents, slowly but surely, causes investors to shift their capital to other cities. Thereby precisely the same aging of structures and deterioration in working and living conditions is brought about in cities that differentially increase sales and income taxes as occurs in cities that increase property taxes.

Increasing Nontax Fees and Charges

In 1965, city governments raised $12.3 billion from such sources as sales of liquor and school lunches, admissions to recreation areas, charges for utilities, hospital services, sewer, and miscellaneous other services. There appears to be some potential for raising substantial sums by judiciously increasing selected fees and charges.

To begin with, certain business license fees might be increased without fear of significantly decreasing total business activity. Particularly effective would be increasing franchise fees of monopolistic activities such as garages, taxes, liquor stores, and taverns. Sewerline, water, and other utility rates also might be increased. Probably demands for these utilities are not as price sensitive as other necessities of city living so that additional revenues could be realized from them.

Increases in charges for public housing, hospital services, admission to recreation areas, school lunches, and the like are possible but this would subvert current policy, which aims at pricing these goods and services below cost to place them within reach of low income families.

In toto, increasing city nontax fees and charges selectively can help to bridge the revenue gap that cities face. The upper limit which can be expected from such increases is probably about 20 percent over the next 10 years, or a total incremental increase of about $25 billion.

Increasing City Debt Financing

Gross city bonded debt has risen rapidly in recent years. In 1960 it was $55 billion and reached $72 billion in 1965, rising at an average rate of $3.2 billion per annum. Net city bonded debt also has been rising in recent years though not so spectacularly as gross city bonded debt. From Federal Reserve "Flow of Fund" data combining incremental net bonded debt of States and cities it appears that for cities incremental net bonded debt has equaled about $2.5 billion per annum in the 1960s.[5] Doubtless part of the estimate of the $262 billion gap between city revenue needs and expectations over the next 10 years can be filled by increasing net city bonded debt. In fact, since much of the gap is attributable to capital spending for housing and public facilities a substantial part of the required $262 billion should be raised by bond sales. However, there are some problems associated with this approach.

City government credit ratings are likely to be inversely related to their budget gaps. Thus, the interest expense of financing capital projects tends to be highest where the need for such improvements is the greatest. Reliance on capital markets for continuing flows of funds also ties the timing of projects to money market conditions, introducing delays of needed public projects because interest rates are high—as they often are.

Because of the added costs and timing inefficiencies that arise as a corollary of bond financing it would not appear prudent to finance more than that part of the revenue gap which can be attributed to needed capital outlays. Thus, since capital outlays, including those for housing, amount to 23 percent of the projected total local spending, at most only 23 percent of the $262 billion revenue gap, or $63 billion, should be raised by increasing net city bonded debt.[6]

LARGE METROPOLITAN AREAS

The preceding discussion suggests that cities are inefficient tax collecting units of government. The next question that suggests itself is

[5] Incremental net bonded debt is equivalent to negative saving. In any given period it equals the algebraic sum of gross bonded debt issued less redemptions and securities purchased.

[6] Regardless of the extent to which cities must rely on long-term borrowings to meet their future revenue needs, it appears desirable to eliminate existing barriers to effective city utilization of money markets. One important barrier is the limit placed by many states on local issues of general obligation bonds. This forces cities to issue special revenue bonds which carry higher interest rates than general obligation bonds, which are backed by the taxing authority. Additionally, because banks are not allowed under present law to underwrite revenue bonds, the interest rates of revenue bonds are higher than they would be in a more competitive underwriting market.

whether metropolitan areas consisting of neighboring cities and their suburbs can solve their collective revenue problems efficiently by combining their efforts, assuming that such metropolitanwide taxing authorities are politically feasible.

Large metropolitan areas would increase the difficulty of moving for tax avoidance purposes, but this advantage is not really substantial except in the short run. Even here it is important only in respect to movements of population, not investment capital, because investment —especially new investment—is mobile. Thus, making metropolitan areas responsible for raising the additional revenues required by cities would have little more stabilizing effect on the allocation of our national resources than leaving this responsibility with the cities themselves.

The principal benefit that would be derived from metropolitan taxing authorities would be more equitable distribution of total metropolitanwide tax loads. This would be a significant achievement since per capita costs of government in core cities are increased by increases in the populations of their suburbs (reference 4), but under present taxing practices suburban populations do not pay for the core city cost increases they induce.

STATES

In 1965, city governments received a net $15.2 billion in intergovernmental financial aid. Of this, $15.2 billion, a minimum of $4.1 billion and a maximum of $9 billion came from the States, with the exact amount being indeterminate.[7] Of course States also spent additional billions of dollars in 1965 directly on schools, hospitals, highways, and other governmental functions, thereby reducing the responsibilities of city governments. But this does not alter the fact that only $4.1 to $9 billion was provided by States to cities to pay for the services for which cities are responsible. From these data it appears naive to expect States to provide a major part of the $262 billion revenue that cities need over the next decade to again become viable socioeconomic entities. The States are either unwilling or unable to fill much of the gap. Further, the desirability of their doing so can be questioned, as some of the same arguments that apply to the undesirability of cities closing their income gaps unassisted also apply to States.

For example, increases in State aid to cities would be desirable only if such increases did not result in differential tax rates among the States, which in turn would induce interstate flows of investment capital and other resources. Although the effect would be less severe than that caused by local tax rate differentials, there would still be a reduction in the overall efficiency of the national economy. Certainly State lines cannot block the transfer of marginal units of capital and other resources to locations where the payoff is highest any more effectively than can county or city boundaries. Nor does distance have appreciable effect on the cost of transferring financial assets, and hence the location of new plant and equipment.

[7] The range was established as follows: Federal aid to both State and city governments totaled $11.1 billion in 1965; therefore, State aid totaled at least $4.1 billion ($15.2–$11.1 billion). Inspection of Federal grants-in-aid for 1965 item by item indicates that the Federal Government supplied at least $6.2 billion to city governments, making the maximum total State aid $9 billion ($15.2–$6.2 billion).

Despite the foregoing, from the standpoints of administrative efficiency and potential for raising revenues with minimal effects on the personal distributions of wealth and income, there is no doubt that States can put together more acceptable tax packages than can localities. Thus it would appear desirable to place as much revenue-raising responsibility as is politically feasible with the States as opposed to localities. Based on the 1965 estimates of $53 billion for local revenues and $4.1 to $9 billion for State aid to city governments, State aid now runs between 8 and 17 percent of city revenues. Since State revenue needs are not growing as rapidly as city revenue needs, State aid might be increased by 50 percent in the 10-year period ahead. Thus, assuming that the States' share of the responsibility for supplying public facilities and services in urban communities does not change in the coming decade, they could provide 19 percent (1.5 times the average of 8 and 17 percent) or $49 billion of the $262 billion revenue gap facing city governments in the 1966–75 period.

THE FEDERAL GOVERNMENT

The Federal Government has the greatest potential for closing localities' revenue gap efficiently, fairly, and effectively.

The resource allocation repercussions from attempts to avoid Federal taxes are relatively small compared to State and city taxes because Federal tax obligations cannot be avoided by intercity or interstate moves. Also the Federal Government administers tax programs with less effort per dollar collected than State and city governments.

Because it can rely heavily on the income tax, the Federal Government is in the best position technically to formulate a tax program that treats equal incomes equally and taxes all incomes progressively.

Today, the Federal Government is in a better position financially than State or local governments to raise additional tax revenues without undue political friction. One reason for this is that since 1953, when the Korean war ended, per capita taxpayments to city and State government have increased more rapidly than those to the Federal Government. Between 1953 and 1963, per-capita tax revenues of the Federal Government rose by $80,[8] while those of State and city governments combined increased by $112. Moreover, the incremental increase in the burden imposed by the States and cities is understated since the figures make no allowance for increases in utility and other charges.

Though data are not available, it is likely that the Federal tax cuts of 1964 and 1965 magnified this trend of per capita tax obligations rising more rapidly at the city and State levels than at the Federal level. Thus, to the degree that taxpayers look upon their tax bills as independent bills and remember increases in them, the Federal fiscal authority would appear to be in the best position to obtain approval of a tax increase from the electorate if such as increase is needed.

However, assuming no major future increase in the Nation's defense budget requirements, it appears possible for the Federal Government

[8] Were it not for defense spending following the Berlin Wall and Cuban missile crises, the rise in Federal taxes would have been even less—about $61 per capita instead of $80 in the 1953–63 period.

to raise a substantial part, if not all, of the total $262 billion deficit without increasing Federal tax rates. This is because Federal tax collections tend to rise relatively sharply as a result of economic growth. Between 1964 and 1965 Federal tax receipts, excluding social insurance taxes, rose by $9.4 billion while GNP was rising by $47.6 billion. This means that under present Federal tax rates we can expect 20 cents in Federal tax revenues for each $1 increase in GNP. In turn, this means that if GNP grows by 4 percent per year, Federal tax revenues will be $32 billion greater in 1970 than in 1965, $62 billion greater in 1974, and $72 billion greater in 1975. Cumulatively, during the next 10 years, the increase would be $365 billion.

Of this sum it is probable, on the basis of trends in present Federal grants-in-aid programs, that $60 billion is presently committed to States and cities.[9] Thus only $305 billion of the projected cumulative increase in Federal revenues during the next 10 years is in fact available for expanding defense spending, rebating funds to the States, cutting Federal tax rates, increasing the rate of growth in assistance provided to cities above present trends, and so forth.

Assuming no major increase in defense budget requirements, it is feasible over the next 10 years to increase Federal appropriations to city governments by $125 billion, the residual amount required to close the $262 billion gap. This amount would be equal to 40 percent of the uncommitted estimated incremental Federal tax revenues in this period.

Because, as the analysis has demonstrated, the revenue-raising activities of the cities themselves and the States are constrained by tax avoidance possibilities. Federal funding on this scale is absolutely essential for making real as opposed to token progress in solving urban problems.

Section 3: Administering Federal Aid to Cities

This section discusses options for administering Federal funds made available to city governments. It is imperative to answer the following two questions: First, how should these funds be routed; should they be channeled to cities through the States without instructions as to the ultimate division among cities and use in each? Second, where funds are routed directly to cities what administrative philosophy produces the most efficient match between problems and funds? In what follows the question of routing funds through the States without instructions is first considered. Subsequently several ways by which Federal financial assistance might be provided directly to cities (and counties) are discussed.

ROUTING FEDERAL AID TO LOCALITIES THROUGH THE STATES

A powerful argument for routing Federal funds to city governments through the States is that our federalist tradition assigns responsibility for the government of cities to the States. This tradition is not inviolable but we should be cautious about breaking it without good

[9] The part of the $60 billion which goes to cities was included in the normal growth of presently programed intergovernmental aid of $72 billion.

reason and without otherwise assuring against undue Federal concentration of power.

On the other hand there are compelling reasons for not allowing the States to administer or even to decide how to allocate Federal funds intended to aid localities. If given power to administer such funds as they see fit, it is naive to believe that the States would not divert some of the funds to other uses. Nor is it enough that the States be given functional instructions on how to use these funds— that is, instructions on how much money is to be spent on community health programs, education, urban beautification, and so on—but left complete freedom in allocating the funds among cities. Probably the best distribution that could be expected from States would be a division by population. But this procedure is defective because it makes no allowance for differences among cities in fiscal needs and capacities. As a result it would shortchange cities with relatively high per capita fiscal needs and relatively low fiscal capacities.

Federal aid can be routed to cities in accordance with their relative fiscal needs and capacities without violating traditional Federal and State roles. The funds can be allocated to the States with instructions for distribution among their cities and counties. The distribution formula would be determined by the Congress and the States would serve as channels as they do now for many programs. However, using the States as a conduit is justified only if the States add value to the services being supplied. Where this is the case, as in the highway program for example, it is sound both economically and politically to route Federal aid to cities through the States. But where the States add no value, economic analysis weighs against passing Federal aid to cities through the States, for this necessarily involves additional administrative costs.

OPTIONS FOR ROUTING FEDERAL FUNDS TO CITIES

Regardless of whether they are given directly to cities or routed through the States, there are four major methods for applying federally collected funds to the problems that appear at the local level.

1. Grants-in-aid for single-purpose specific projects.
2. Grants-in-aid earmarked for a broad purpose such as education—sometimes called functional block grants.
3. Grants-in-aid for multifunction or multiproject programs.
4. Unassigned grants-in-aid, sometimes called block grants.

The benefits and costs of each method of assistance are explored below.

Grants-In-Aid for Single-Purpose Specific Projects

Historically, nearly all Federal grants-in-aid have been made on a narrow single-purpose project basis. Assistance for housing includes grants to demolish unsound structures, to provide low-rent housing for low-income families, to prevent urban blight and rehabilitate dilapidated structures and areas, and to acquire, develop, and preserve open space urban land for public use. Grants have been made to meet the educational needs of culturally deprived children, to compensate for the impact on local school budgets of defense spending and other

Federal activities, to acquire textbooks and other instructional and library materials, and to establish and maintain guidance counseling and testing programs to identify and assist able students. Examples in urban transportation include grants to construct and improve mass rapid transit facilities, to develop public airports, and to construct an interstate highway system.

Grants-in-aid for single-purpose specific projects necessarily must be jointly administered by Federal and local personnel. Federal personnel involved are thus exposed to the experiences of cities in carrying out the purposes for which aid was appropriated, making it possible to apply information gained from previous grants to current grants.

Putting Federal aid to cities on a single-purpose specific project basis permits the Federal Government to develop well-defined minimum standards of performance for each project. Making initial requests for aid contingent on promised performance, and requests for renewals contingent on past performance, provides inducement for cities to perform up to standards.

Grants for single-purpose specific projects allow the Federal government to attack specific problems with well-defined, limited projects. For example, the educational problem that results from culturally deprived children can be attacked by grants for preschool training, i.e., "Operation Headstart." No other grant-in-aid method permits this type of problem-by-problem approach.

Single-purpose specific grants have disadvantages as well as benefits. From a strictly administrative point of view such grants tend to be excessively costly, and the more detailed the specification the more costly the administration of the funds. Unfortunately, we must expect a mass of detailed specifications if Federal funds are allotted to cities on a project-by-project basis. Further, the fact that multipurpose programs often must be approved by as many different agencies as there are specific purposes in the program discourages the planning of programs that integrate spending in diverse but interrelated problems areas. For this reason specific single-purpose grants make it difficult for cities to plan, coordinate, and carry out balanced multipurpose programs. Grants for highway construction provide an example of the unexpected effects and imbalances that can result from single-purpose specific grants. The billions of Federal dollars spent on highways since 1956 have directly caused major distortions in land use patterns and indirectly caused other elements in our transportation system to atrophy.

Of course in a technical sense, project-by-project assistance does not prevent coordination. Certainly, cities still are free to plan variously scaled programs of balanced development, but it is unrealistic to expect them to carry out multipurpose programs without Federal assistance for all eligible component projects or programs. If Federal aid for one of the component parts of a multipurpose program is not currently available, the prudent city administrator will not commit city funds to completing the work but rather will wait until Federal funds are granted.

The single-purpose specific project grant system also discourages innovation at the city level because of the need for local authorities to

obtain approval of grant applications. They would be less than human were they not to copy as closely as possible previous successful applications.

A penalty of single-purpose specific project grants is that they inhibit flexibility in spending because of the requirement for annual review by the granting agency. Few city administrators will risk abandoning or modifying a project even though the environment has changed. Groundless or not, they will fear that abandonment of a project may be used in future years as an excuse by the authorizing Federal agency to deny requests for other grants in this problem area. Similarly, they will fear that modification will cause more critical review of renewal applications.

Because grants for single-purpose specific projects are distributed to cities independently of their relative fiscal needs and capacities, we cannot possibly hope to assure the viability of U.S. cities by such grants. In fact, when this type of grant procedure is used, it is conceivable that total aid received by individual cities will be correlated less with the gap between fiscal need and capacity, than with their salesmanship and political "muscle."

To summarize, the essential feature of single-purpose specific project grants-in-aid is that they are designed to achieve specific goals. In an historical context this has been the major reason for their genesis and continued use. In earlier years the amount of total funds was simply too small to permit any approach except sharpshooting at particular targets. But today additional resources permit implementing various other approaches.

Grants-in-Aid for Use in Broad Functional Areas

As indicated in the preceding analysis, local spending patterns—even within broad functional areas such as housing, education, and transportation—are presently constrained and even molded by the availability of single-purpose, specific project grants. To give an example, Federal funds are not currently available to provide parking facilities in downtown areas. As a consequence, cities with critical downtown parking problems may choose to appropriate funds for airport development instead, even though the need is less critical, because the Federal Government will put up 50 percent of the cost.

Granting Federal aid to cities with only broad instructions to recipients on use of the funds would at least permit local administrators to relate their expenditure budgets to their spending priorities in broad functional areas such as transportation, housing, education, and sanitation. In terms of the above example, local initiative could be exercised and top priority in spending could be given to developing the critical parking facilities.

By definition, this system of allocating Federal aid to cities rules out setting performance standards for specific activities. However, it does allow setting standards in the grant's broad area. (Thus, education grants might set maximum age standards for textbooks.) If specific projects do not require approval, substantial savings can be achieved in administrative and clerical expenses.

The authority responsible for allocating broad "functional block" grants necessarily is not concerned with the merits of specific spending

proposals but rather how to divide the total available funds appropriated, say, for housing, education, and urban transportation among cities. This makes it possible to allocate aid shares to cities based on their relative fiscal needs and capacities. This is a more rational allocation of funds than providing dollars to cities than can identify a single problem and propose a solution that falls within the purview of a Federal agency.

A disadvantage of "functional block" grants is that some specific problem areas might be neglected, especially in cases where solving the problem does not directly benefit the guarantee. For example, a city dependent upon a marginally pure river for its domestic water supply would be strongly motivated to install a purification plant if given a grant to provide improved sanitation services; it would be less motivated to spend the money to purify its own industrial and household wastes before dumping them downstream.

Grants-in-aid that must be spent in a particular functional area such as housing, education, or welfare make it difficult for cities to plan and carry out the multipurpose programs that are required to achieve balanced development. To begin with, "functional block" grants, like single-purpose specific project grants, give cities incentive to divert their own resources to those areas where Federal funds are most readily available on a matching basis. For those cities whose most urgent needs are in the "functional blocks" in which adequate Federal funds are available on short notice, this presents no problem. But other cities may be drawn into overdeveloping some activities or public services at the expense of others. This possibility of uneven development is increased because all of the consequences of actions in a problem area often cannot be foreseen.

Grants-In-Aid for Multipurpose Projects and Programs

Perhaps the most frustrating aspect of specific grants-in-aid is that when a city seeks Federal funds to implement a well-defined, multipurpose program it cannot request all the funds from a single review board, but must request specific funds from each Federal and State agency with jurisdiction over any part of the total program. Often this means long delays in starting the program while waiting for approval from each of many agencies. In other cases, part of the program will be turned down and thus threaten the whole program. Yet these delays and uncertainties are unnecessary. They could be avoided by constituting interagency committees with representatives from concerned Federal agencies who would be empowered to review requests by cities and commit the agencies' funds for multipurpose programs.[10] In part, this is the approach to be taken under the Model Cities Program; however, dollar priorities continue to be a problem under this program.

[10] One mechanism that might be used to offer cities an alternative to specific single-purpose grants would be to establish an Urban Development Fund administered by the Department of Housing and Urban Development. Cities would have the option of submitting applications to HUD for funds for multipurpose programs. HUD would convene ad hoc committees to represent all Federal agencies which applicant cities would otherwise have to approach separately. The ad hoc committees would review applications to be certain that they satisfied technical requirements of related national programs. Cities whose applications were approved by the committee would be required to forfeit their rights to apply for separate specific grants from the concerned agencies and would receive deposits for a specified Federal share of the cost necessary to carry out their total programs.

This procedure for the review of city requests for Federal funds for multipurpose programs has two distinct administrative advantages over the "piecemeal" review which is inherent in the specific grants-in-aid system. First it permits cities which are planning a multipurpose program to determine relatively quickly whether Federal funds are available for all parts of their program. Second, it enables Federal administrators to review city requests for funds from their agencies in the context of the overall plan which the city expects to carry out.

For cities, the multipurpose grant-in-aid system would encourage integration of interdependent activities in their programs, thus minimizing situations in which failure to perform one activity defeats the purposes for which another is carried on.

The philosophy underlying multipurpose grants is that many city problems must be attacked collectively, not singled out for special attention. But no doubt there are some problems that are properly viewed as isolated questions and thus do not lend themselves to the multipurpose grant-in-aid system.

A possible cost of multipurpose grants is associated with the necessity of drafting a detailed plan of action covering several interrelated problem areas and defending the plan before a Federal review committee. This might seriously stifle experimentation in the planning stages due to attempts of applicants to reduce any uncertainty of a plan being approved. Similarly, if plans are reviewed on a yearly basis the initial plans will tend to define future plans.

Like specific grants-in-aid programs, multipurpose project grants are not designed to deal with the vast differences in overall fiscal needs, capacities, and prerogatives among U.S. cities. This is a major deficiency in a system wherein grants are made for multipurpose projects, since cities with minimal fiscal capacities may be least able to afford the formidable planning, proposal, and briefing activities that might become prerequisite to obtaining approval of requests for funds. Although these activities need not play an important part in the approval process, they usually do.

Unassigned Grants

The fourth way of appropriating Federal aid to cities is by granting "block" sums without any restrictions concerning their utilization. However, unassigned grants need not be made unconditionally. Grant renewals can be contingent upon the results of a financial audit. This would safeguard against corrupt or inefficient use of Federal funds, and also assure that minimum standards of performance are satisfied.

In allocating aid by specific grants, whether single or multipurpose, the authorizing agency is not confronted with the problem of weighing a city's share of total aid to determine whether to approve or disapprove its requests for funds. The agency need only consider whether the city has a problem falling within its program scope, and whether the city's proposed solution is sound. The ultimate result is that total Federal aid is distributed to cities without the distribution of the shares being questioned, (if, in fact, it is even known at all). In contrast, if unassigned Federal grants are to be made to cities, the desired distribution of these grants must be determined before the system can become operational. The ideal solution would

be an allocating procedure that automatically and equitably allocates aid among the Nation's cities on the basis of their relative fiscal needs and capacities.

The development of an allocation formula requires first the selection of appropriate factors to define the relative fiscal needs and capacities of the Nation's cities, and then the assignment of appropriate weights to these factors. For example, in a given base year a city government system might receive the sum of $30 for each resident, $50 for each resident living in a household where per capita income is less than $1,500 per year, $10 for each nonresident employee, and $1,000 for each $1 million of "full faith and credit" debt outstanding—divided by the reciprocal of the fraction of all local taxes collected in the home county in a base year by the city in question. Under this formula a city of 2 million residents with 400,000 of them living in low-income households, 200,000 nonresident employees, and $1,000 million in eligible debt outstanding which collected one-half of all local taxes collected in its home county in the base year would receive:

$$\begin{array}{rl} 2,000,000 \times \$30 = & \$60,000,000 \\ 400,000 \times 50 = & 20,000,000 \\ 200,000 \times 10 = & 2,000,000 \\ 1,000 \times 1,000 = & 1,000,000 \\ \hline & \$83,000,000 \div 2 = \$41,500,000 \end{array}$$

Neither the above allocation formula nor the factors used are intended to be definitive. Its purpose is strictly to illustrate that it is possible to develop a formula that will allocate funds among city systems in accordance with their relative fiscal needs and capacities.

Giving a workable allocation formula, the actual allocation of unassigned Federal aid among cities could be programmed on a computer to minimize administrative expense. Cities would know how much Federal aid they could rely on from this source when they made up their overall budgets, for presumably they would know both the amount of the total Federal appropriation and the allocation formula. Thus localities would be better able to plan and administer their total fiscal affairs.

The unassigned grant system can be made to serve any desired distribution goal. For example, aid can be distributed to close gaps between revenue needs and revenue expectations confronting individual cities and thereby help assure the renewal and continued development of those of our cities which now threaten to become permanently incapable of serving as metropolitan and regional hubs.

Unassigned block grants, by definition, permit cities to use Federal aid as they see fit. This freedom gives them maximum flexibility in planning, reviewing, and modifying their expenditures. They are not tied to specific projects and programs, nor are they restrained either explicitly or because of fear of Federal disapproval from changing plans or modifying programs already in effect if circumstances so dictate. They are not even constrained to use the aid in some broad functional area such as education. In particular, this will encourage city planning and budgeting which attempts to achieve an overall unity of city functions.

The one substantive criticism of unassigned grants is that they are

not likely to be used in all-out attacks on top-priority problems having regional or national implications. Realistically, cities will not voluntarily use scarce financial resources for such regional and national purposes as controlling water pollution, where the benefits of such activity accrue mostly to downstream cities, or aiding dependent children, when there is a possibility of attracting households with such children from cities not taking such action; and so forth. Thus a system of unassigned grants will tend to leave such problems unsolved, no matter how pressing they may be.

SUMMATION

In reviewing the cost and benefits of each form of aid a match emerges between the geographical dimensions of the problems being addressed and the form of aid to be used. Some types of aid would appear to be particularly suitable for solving purely local problems and others for treating problems that are metropolitan or regional in character. Grants-in-aid for specific single-purpose projects would appear to be best suited for dealing with problems that transcend city boundaries, such as controlling water pollution in a given river system, facilitating transportation in a metropolitan area, and constructing the Interstate Highway System. "Functional block" grants which cover broad areas give the city increased flexibility in setting priorities —still within the framework of those problems considered to be of such natonal importance as to require striving for some minimum acceptable national standard. Grants for multiproject programs will give local administrations a greater challenge and opportunity to identify and respond to complex local needs with integrated solutions but would still require the approval of the Federal granting agency.

In cities where the interplay between the social, economic, and physical aspects of urban problems that are purely local in character is already most complex, the unassigned grant gives city administrators the challenge and fiscal capability to deal flexibly and effectively with the unique characteristics of the problems of his city. As the quantity and complexity of grant-supported programs grows during the coming decade, administrative flexibility is going to become crucial to their successful executition.

A full analysis and detailed classification of the local versus regional (or even national) dimensions of the services that must be performed to assure the viability of our cities is beyond the scope of this paper. But whatever the appropriate classification may be it is clear that Federal aid must be similarly classified.

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Part 3

IMPROVING CONDITIONAL GRANTS-IN-AID

THE EFFICIENCY OF CONDITIONAL GRANTS-IN-AID

BY ROBERT W. RAFUSE, JR.*

Much of the appeal of recent proposals for Federal revenue sharing with State and local governments appears to derive from a premise that is rarely made explicit. The premise concerns the existing system of conditional grants-in-aid. It is the growing conviction that such programs in practice, and indeed by their very nature, are an inefficient method of pursuing the basic goals of public policy.

If there is anything to this appraisal of the revenue-sharing debate, it is not a little surprising that the question of efficiency rarely arises in current discussions of conditional grants. The primary reason for this curious state of affairs, at a time when the issue of efficiency has never been more popular in Washington, is the fact that a satisfactory definition of an efficient matching grant is yet to be developed.

This paper is an attempt to satisfy the need for such a definition. In the following pages a concept of efficiency is developed that is applicable to the analysis of conditional grant programs. Several implications for various aspects of grant legislation are then considered briefly.

EFFICIENCY AND PROGRAM OBJECTIVES

Efficiency, as we have been reminded so many times in recent years, lends itself to two complementary definitions. It is the achievement of a specified objective at minimum cost (broadly defined). Alternatively, it is the attainment of the maximum possible amount of a desired object for a given investment of resources. The fact that a measurable objective or unit of output is crucial to both meanings suggests several reasons why the discussion of conditional grants-in-aid has tended not to focus on the issue.

Three facts regarding the objectives of current grant-in-aid policies seem to account for the dearth of serious attempts to analyze the efficiency of federal matching grants. First, consensus on program objectives does not always exist. Second, where there is agreement, the objectives agreed upon are often not amenable to measurement. Finally, serious attempts are rarely made to define objectives in a meaningfully explicit way in those instances in which quantification is acknowledged to be appropriate.

The view outlined in this paper does not assume that efficiency is everything. No more is implied than that, if efficiency is desired, an attempt should be made wherever possible to define the objectives of grant programs in terms that are amenable to measurement and rigorous analysis. In no sense does this imply that nonquantifiable goals

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are inferior or are not as worthy of pursuit as goals that can be measured.

The fact remains that many, perhaps even most, grant programs do seem to involve measurable objectives. But in virtually every one of these cases the objectives have been permitted to remain implicit. As a consequence, the efficiency of the programs has not been subjected to the sort of evaluation that is entirely feasible and proper. At the very least it would seem that the absence of such analysis warrants a presumption that substantial inefficiency exists. In other words, recasting programs after careful analysis of costs and objectives could result in more services in return for present budget outlays, or in attainment of the same levels of service at lesser expense.

The abundance of vague and nonoperational statements of the purposes of Federal conditional grants-in-aid—for example, relief of a State-local fiscal crisis—should not be permitted to obscure the fact that many knowledgeable observers view the functions of conditional grants in ways that lend themselves to a definition of efficiency. The most important of these views has been around for many years—at least since the 1930's.[1] This approach describes the primary objective of Federal conditional grants as the achievement of minimum levels of certain public services that are peculiarly imbued with the "national interest." [2]

A slightly different concept of the function of a conditional grant is exemplified by the provisions relating to the Interstate Highway System in the Highway Revenue Act of 1956. This grant program is intended to secure a very specific objective—only in the sense that minimum technical specifications are prescribed by the Bureau of Public Roads can it be said that a minimum rather than a fully defined service-level objective is involved.

For purposes of this discussion of efficiency, the objective of a Federal matching-grant program is defined as the attainment of a specified service-level. For example, the goals of the vocational rehabilitation program have for many years been expressed in terms of specific service-level objectives. In 1954 President Eisenhower defined the objective of the program for the following year as the rehabilitation of 70,000 individuals, with a long-range objective of 200,000 rehabilitations per year by 1959.[3] Although the service-level objectives for 1955 and 1959 were not achieved, in proposing amendments to the legislation in 1964 President Johnson explicitly reaffirmed that the objective is the rehabilitation of 200,000 individuals per year.[4]

The Vocational Rehabilitation Administration considers the incidence of vocational disability to be distributed in proportion to population throughout the United States. This suggests that implicit in the above statements of national objectives is a set of State-by-State objectives, broken down according to population. Indeed, such a break-

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[1] See, for example, V. O. Key, Jr., *The Administration of Federal Grants to States* (Public Administration Service, 1937), p. 374.

[2] For references to this objective see, in addition to Key, The Council of State Governments, *Federal Grants-in-Aid: Report of the Committee on Federal Grants-in-Aid* (1949), p. 106; and the Advisory Commission on Intergovernmental Relations, *The Role of Equalization in Federal Grants*, No. A–19 (1964), p. 10.

[3] *Congressional Quarterly Almanac:* 83d Cong., 2d session. . . . 1954, vol. 10 (Congressional Quarterly News Features, 1954), p. 213.

[4] *Congressional Quarterly Almanac:* 89th Cong. 1st session. . . . 1965, vol. 21 (Congressional Quarterly Service, 1966), p. 339.

down, providing for a service-level objective for each jurisdiction to be aided, is presumably implicit in every statement of national objectives. In the absence of such specification of objectives for each jurisdiction, the most efficient distribution of Federal funds would be likely to involve only a very limited number of jurisdictions. For this reason, the statement of objectives is likely to include, implicitly at least, provision for the achievement of some minimum service level in each eligible jurisdiction.

Once the set of desired service levels is decided upon by the Congress, the magnitude of the problem to be dealt with by the grant-in-aid program is indicated by the gap between the objectives and the service levels believed most likely to result in the absence of the Federal program.

Whether the set of service-level objectives is referred to as a national minimum, as in the case of certain welfare programs, or as completion of a particular portion of a specific system, as with the interstate highway program, in the end is only a question of semantics. The objectives may be uniform among all the jurisdictions relative to some general index such as population, or they may be defined by some completely nonuniform set of criteria, as in the highways program case. The source of the set of objectives, in other words, is not important as far as the issues being considered here are concerned. In the technical terms of program analysis, the problem is here defined to be one strictly of suboptimization. A grant program is efficient if the total cost to the Federal Government of achieving the service-level objective in every jurisdiction is at a minimum.

Designing an Efficient Matching Formula

The basic steps involved in designing a grant-in-aid program that satisfies the two criteria of service-level achievement and efficiency are summarized briefly in the following pages.

A basic premise regarding the behavior of State and local governments should be made clear at the outset: that in certain important respects individuals behave in official capacities approximately as they do as private consumers. One of the fundamental propositions of economics is that consumers normally react to a decline in the price of a commodity by increasing their purchases of the item. The same proposition seems plausible with respect to the behavior of decision-makers in the public sector. A drop in the price of playground equipment or police cars may reasonably be expected to lead to larger quantities being purchased by local officials. The specific increases in quantities purchased are likely, of course, to vary from community to community, just as did the amounts purchased before the prices fell. Putting it somewhat differently, a uniform price decline is likely not to result in the same percentage or absolute increases in the purchases of every community. It is this likelihood that makes the job of the grant-program designer a difficult and delicate one.

The fiscal effect of a Federal matching grant is to reduce the price of the aided service, when the situation is viewed from the vantage point of an eligible State or local government. When the Federal Government offers to pay 90 percent of the cost of a portion of the Inter-

state Highway System, the price of that project to the State receiving the grant is only 10 percent of the true "market" price. Similarly, the Vocational Rehabilitation Administration is in the business of offering a 75 percent discount on the market price of rehabilitating handicapped individuals. Thus, just as a private businessman looks upon lowering prices as a way of increasing his sales, so Federal grant administrators ought to view matching provisions as a method of reducing prices to induce State and local governments to increase their purchases of aided services.

The response of a State or local government to a grant-induced price reduction is, of course, just as voluntary in every sense of the word as is the reaction of an individual consumer to an analogous price decline. It seems reasonable to suspect that the highly voluntaristic character of the fiscal relationship between grantor and grantee is a major reason for the fact that the matching grant is the cornerstone of intergovernmental fiscal relations in the American Federal System. Whether recent development in the nonfiscal aspects of Federal grant policy are fully compatible with a voluntary relationship of this sort is an issue that deserves the most careful study. To consider the question further here, however, would involve too great a departure from the theme of this paper.

The fact that the effective demand for public services is not everywhere the same, coupled with the fact that the service-level gap differs from community to community, implies that a uniform, across-the-board drop in the price of the aided service—the effect of uniform Federal matching—will fail to satisfy one or the other of the basic criteria. A uniform Federal share that reduces the price sufficiently to achieve the service-level objective for the community or State with the weakest demand for the service will throw money away on "excessive" service levels in areas with stronger demands. Conversely, to avoid giving excessive aid to any recipient, use of a uniform matching ratio must imply failure to achieve service-level objectives in others.[5]

The design of a matching formula, then, is a complicated business. The efficiency of the results depends upon how good a job is done of analyzing the demand for the service in question. Ideally, the formula will provide for a Federal matching share (price reduction) for each potential grant recipient that will just be sufficient to induce an increase in purchases to the service-level objective defined by the Congress.

A simple hypothetical example may help to crystallize the argument of the past few pages. Suppose the Congress decides that the national interest requires that laboratory facilities of a given (superior) quality should be available to every high school student in the United States. Some schools, we may suppose, already provide such facilities, some have good but overcrowded laboratories, others are substandard, and some schools have none at all. The most efficient method of achieving this objective, as well as the one most consistent with the traditional

[5] The prima facie inefficiency of uniform matching ratios has been pointed out by the Advisory Committee on Intergovernmental Relations [*The Role of Equalization, op. cit.*, pp. 75 and 76]:

* * * there seems to be little logic in requiring all States, regardless of their relative fiscal capacities, to match Federal grant funds in the same proportion. * * * This appears unduly generous to the more affluent States which probably would continue to provide these programs even with less Federal aid.

American approach to elementary and secondary education, would involve a matching-grant program designed according to the procedure outlined in this paper.

A careful study of the provision of laboratory facilities would be undertaken with a view to identifying the factors that are the most important determinants of the policies of school districts with respect to such facilities. Such a study might establish that the demand for laboratory facilities is directly related to the following factors: the average personal income of the community per school-age child, the proportion of the adult population with a college degree, and the size of the school district. On the basis of this information it would be possible to define a grant formula that would make the Federal matching share a specific inverse function of the three variables. The result would be no more than a crude approximation to the theoretically desirable formula, since the true demands of school districts can only be estimated from historical data. It would, however, be a considerable improvement over methods presently in use, which are not really designed to produce information about demands, and which result in formulas that rely exclusively upon such gross variables as population and personal income for virtually every program.

Efficiency and Equalization

Proposals that conditional grant-in-aid programs should include "equalization" provisions appear increasingly to be based upon reasoning not inconsistent with the approach outlined in this paper. In general, a program is usually said to be equalizing if the Federal Government's share of the costs of the aided service is inversely related to the fiscal capacity of the grant recipient; if, that is, the Federal Government pays a larger proportion of the cost of the aided service for a low-income State than it does for a high-income State.[6]

For many years the objective of equalization seems to have been viewed by many as the redistribution of income from richer States to poorer States—the equalization of the fiscal capacities of the States. Because proposals for equalization originated in the 1930's the fact that this view caught on quickly is not surprising, given the generally equalitarian sentiment that prevailed during those years.[7] In recent years, however, equalization has come to be interpreted in a far more pragmatic way.

Nonetheless, the continuing appeal of the view that a major objective of equalization provisions is the redistribution of fiscal capacity among the States appears to lie behind persistent efforts to measure the relationship between total Federal grants and State personal income.[8] Several economists have considered the question of general equalization measures, but these efforts do not directly concern the

[6] Although an equalizing pattern of cost sharing could result from a number of different circumstances, the Advisory Commission on Intergovernmental Relations prefers to define equalization in terms of only certain of these, specifically, as the explicit inclusion, in matching and/or allotment provisions, of factors designed to assure this result. [*Ibid.*, p. 4.]

[7] For a discussion of equalization that places heavy emphasis on the objective of income redistribution—among individuals as well as among states and regions—see Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (Norton, 1944), pp. 130 and 131.

[8] This issue is discussed, and several studies summarized, by George F. Break in his recent study for The Brookings Institution [*Intergovernment Fiscal Relations in the United States* (1967), pp. 120–127.]

equalization provisions or effects of conditional grants.[9] Finally, of course, the issue of general equalization has been revived in connection with the debate over Federal revenue sharing with the States. Joseph A. Pechman, for example, bases much of his case for revenue sharing on the desirability of reducing existing disparities in the fiscal capacities of State and local governments.[10]

The pragmatic or functional interpretation of the role of equalization received a considerable boost from a recent report by the Advisory Commission on Intergovernmental Relations. The following passage is a concise statement of the Commission's position:

> While some degree of equalization of income among the States may be a byproduct of Federal grants-in-aid, the purpose of the equalizing feature in an aid program is not geographical redistribution of income but rather the attainment of some national objective, such as insuring a minimum level of essential public services through joint Federal, State, and local action.[11]

The functional view of equalization is clearly a step in the direction of the approach suggested in this paper. The chief shortcoming of the position taken by the Advisory Commission is its implicit assumption that fiscal capacity is the only important determinant of the demand for public services. This is equivalent to saying that all individuals with similar incomes wish to consume equal quantities of a particular commodity or service, without respect to differences in such factors as their educational backgrounds, place of residence, and net worth.

Moreover, reliance upon equalization provisions, alone or in conjunction with such general indexes as population, fails to take account of the fact that the costs of providing given levels of public services often vary significantly from area to area. This is an especially serious problem when the Congress is concerned with service-level objectives at the community level. For example, school buildings of a given quality are reputed to be more costly in central city areas than in suburbia. For an illustration of the possible implications of this fact, consider a case in which the fiscal capacity of a hypothetical central city exceeds that of a neighboring suburban community—a situation that is not entirely beyond the realm of possibility. Suppose further that the demand for schools is exclusively a function of fiscal capacity, as the pragmatic equalization view assumes. Under such circumstances the fact that the market price of schools is higher in the central city may well result, in the absense of Federal aid, in fewer schools being constructed in the city than in the suburb, even though the demand is greater in the city. Yet an equalizing Federal grant that takes account solely of fiscal capacity would provide relatively less aid to the central city than to the suburb. The approach outlined in this paper, on the other hand, deals explicitly with the problem of cost differentials in the initial definition of the size of the service-level gap to be closed by the grant program.

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[9] See, for example, James M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review*, vol. 40 (September 1950), pp. 583–599; and Richard A. Musgrave, "Approaches to a Fiscal Theory of Federalism," in *Public Finances: Needs, Sources, and Utilization* (*National Bureau of Economic Research, 1961*), pp. 97–122.

[10] *Federal Tax Policy* (Brookings, 1966), p. 227.

[11] *The Role of Equalization, op. cit.*, p. 10.

EFFICIENCY AND ALLOTMENT PROVISIONS

The final issue to be considered is the implications of this paper's definition of an efficient grant for a common feature of existing programs. With one important exception, Federal grant programs are "closed." The Congress each year fixes a ceiling on the amount of money available, and the statute establishing the program typically specifies the manner in which the appropriation is to be apportioned among the States. Only grants for public assistance are "open ended," that is, restricted neither by an annual budget ceiling nor by a statutory apportionment formula. If grant-in-aid programs are viewed as devices for achieving particular service-level objectives at minimum cost to the Federal Government, such provisions are either pernicious or superfluous.

If a State's annual allotment is consistently exhausted, as is the case with most existing programs, it is not unreasonable to conclude that the price of the aided service has been reduced by the grant to a point out of proportion to the amount of Federal funds available. In other words, the State would have provided the same service level even if the Federal matching share had been smaller (and the total outlay by the Federal Government correspondingly less). This being the case, it is clear that, if the service level actually achieved is less than the objective desired by the Congress, the effect of the allotment restriction is to frustrate the achievement of the purpose of the grant. If the service level provided exceeds that desired, the Federal matching share was set too high in the first place, and should be reduced. Such a cut in the Federal share would, of course, result in a rise in the price of the aided service, in a decline in the amount of the service purchased, and in an accompanying reduction in the outlay of Federal funds below the original allotment. Hence, with a proper matching ratio the allotment provision is patently superfluous. Certainly, if the matching ratio is defined by the approach outlined in this paper, the allotment device is hardly needed to forestall a spending spree by the States at the expense of the Federal Treasury.

INTERGOVERNMENTAL FISCAL RELATIONS AND EFFICIENCY ANALYSIS*

BY ROBERT F. ADAMS and NEIL M. SINGER

In recent years there has been any number of studies diagnosing the ills of our present intergovernmental structure.[1] This paper is not intended to describe the problem yet another time. Rather, we wish to discuss the trends at all levels of government toward the greater use of techniques of cost-benefit and cost-effectiveness anlaysis and program budgeting. The application of these techniques within the Federal Government has not, as yet, extended into the area of intergovernmental fiscal relations. Moreover, those State and localities which have begun to institute efficiency analysis have not yet applied its techniques on a comprehensive basis.

It is clear that efficiency analysis is a very useful mechanism for improving resource allocation at all levels of government. No matter what form is taken by Federal assistance to State and local governments, therefore, it will be necessary to extend and improve the use by these governments of such allocative methods. Two questions are raised. First, how may the Federal Government encourage States and localities to develop their own applications of efficiency analysis? Second, to what extent must existing programs of Federal grants be modified to be consistent with the use of efficiency techniques at *both* the Federal and lower levels?

THE NEED FOR INTERGOVERNMENTAL AID

A review of the literature on intergovernmental aid reveals a surprising consensus on the possible objectives for such aid. One principal objective is to secure a proper allocation of resources in the public sector at all levels of government. The most frequently mentioned source of misallocation is the existense of spillovers, or externalities, which occur when the provision (or lack of provision) of public services in any one community creates incremental (positive or negative) benefits to individuals outside the community. When these benefits accrue to the Nation as a whole, there exists a related marginal social benefit for the country. Simultaneously, however, this individual community may be in equilibrium with respect to its own activity.

Under these circumstances, public services in this community are being underconsumed, and an extension of public services will improve

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[1] For example, see Break, George F., *Intergovernmental Fiscal Relations in the United States* (Washington: Brookings Institution), 1967, and S. J. Mushkin and R. F. Adams, "Emerging Patterns of Federalism," *National Tax Journal*, XIX, September 1966, pp. 225–247.

the national welfare. For example, the level of education provided in Saginaw may be sufficient for individuals living in Saginaw, but if externalities are present, it is a legitimate goal of higher levels of government to attempt to influence the level of education in Saginaw.

A more elusive rationale, but one which pervades many discussions of intergovernmental problems, is the general feeling that public services at the local level are not being consumed in the "proper" amount. This argument states that competition for resources and the limited fiscal base of many State and local governments result in a situation of inadequate provision of public services. If the Federal Government has an interest in providing for a proper allocation of resources, it follows that the Federal Government should provide the means to help local governments finance an increased level of services.

This rationale is elusive in that underconsumption has not and probably cannot be demonstrated. Most economists in the State and local field are well aware in a qualitative sense of the damage done by competition among governments for limited fiscal resources, but no one has demonstrated quantitatively the extent of the problem.

In summary: the major reason for intergovernmental aid is the inadequate provision of public services by State and local governments. This underconsumption results both from the existence of spillovers and from the inability of local governments to mobilize resources for the production of public services.

THE IMPORTANCE OF STATE AND LOCAL GOVERNMENTS

In the attempt to remedy the underconsumption of local public services, various types of programs have been suggested which meet some or all of these allocative problems. These programs include the shifting of expenditure responsibilities to higher levels of government, various forms of grants with or without matching provisions, tax credits under the Federal income tax, tax sharing, and the negative income tax.

Evaluations of these programs have called attention to differences in the ability of the programs to meet "second order" criteria. Thus, the following questions are often raised. Are economies of scale achieved? Is the program flexible enough to be tailored to local needs? Are we changing traditional ideas about the types of services being provided by different levels of local government? Grading programs on the bases of these other criteria—important though they are—may only confound our search for a more perfect federalism. In considering these issues, we frequently forget that the ability of any of these programs to meet its designated objectives depends upon the efficiency with which local governments spend their increased funds.

In all the suggested alternatives local governments develop the programs, plan for their implementation, and carry out the required details. Various fiscal devices may have differing qualitative and quantitative impacts, but it is always the local government which undertakes to provide the level of service. A critical concern then to the development of an improved fiscal federalism is the strengthening of the internal effectiveness of local governments.

THE EFFECTIVENESS OF STATE AND LOCAL GOVERNMENTS

Although State and local governments are the key to the implementation of any present or future intergovernmental programs, it cannot be said that these governments are in a position to provide services efficiently. In this respect, the following considerations show that there is a great need for "more rational" decisionmaking at the local level.

(1) Far two few State and local governments view their budget decisions in terms of outputs. Standard practices focus upon inputs and line items. Additions or deletions from programs are rarely based upon recognized changes in the level of outputs.

(2) Few decisions at the local levels reflect careful multiyear planning. Budget decisions in any one year are hardly ever related to longrun objectives for a program. When longrun plans are made, they usually appear in capital budgets. However, these plans usually fail to analyze outputs or consider current operational costs.

(3) Finally, new programs are generally undertaken without any degree of systematic analysis as to alternative program forms and costs. The use of such analytical tools as cost-benefit analysis or operations research techniques is more the exception than the rule.

In many cases it is not a lack of interest in what is now called PPBS—Planning, Programing, Budgeting System—in the Federal Establishment that is the stumbling block to the introduction of modern planning and management techniques into State and local government. Rather, the problem is the lack of trained personnel. In many States and localities, budget officers and agency planning employees who are interested in these techniques are already overburdened with the routine of budget preparation without raising the issue of analysis in depth.

EFFECTIVENESS AND INTERGOVERNMENTAL GRANTS

Improvements of the internal management of State and local governments would in itself substantially reduce existing problems and would insure more effective use of resources made available by tax sharing or tax credit schemes. However, there are other aspects to this effectiveness problem which concern existing and potential grant programs. The introduction of PPBS within the Federal Government raises several new issues which affect the operations of State and local governments.

First, is the present structure of grants consistent with a cost-effectiveness program at the local level? Are the narrowly defined grants, encumbered by technical requirements, the best instruments for encouraging effective management? We suspect that existing Federal administrative standards reduce the opportunity for creative consideration of alternative programs. This problem is made more severe by the fact that many grant programs do not have appropriate output orientations to begin with.

Second, the implementation of PPBS in many agencies will involve evaluations of the effectiveness of grants by different levels of govern-

ment. It is not obvious that if local communities also evaluate their programs on a cost-effectiveness basis, the two evaluations will be mutually consistent. For example, any program which yields benefits external to the local community obviously will be more desirable from a Federal than from a local viewpoint. Whose evaluation should take precedence? Whose welfare are we trying to maximize? These are not new questions. The introduction of PPBS at all levels of government, however, by its nature will bring these questions out in the open from behind the facade of qualifications standards.

Third, to achieve a modern management approach throughout our governmental structure, we must reevaluate the methods by which funds are allocated to States and localities. Too often, funds are provided on the basis of factors other than program effectiveness. Although we have no measure of the extent of the problem, we suspect that in individual grant programs, some States have more funds than they could spend effectively and other States have urgent needs and viable programs, but insufficient funding. This problem arises because of our schizophrenic grant policy. On the one hand, we want to attain our allocative objectives within the public sector; and on the other hand, we make funds available as if we were redistributing income. The problems of the public sector are not randomly distributed around the country, nor are they simply a function of population size or per capita income.

It would be naive for us to suggest that there is any easy resolution to the question of equity versus efficiency. But grants-in-aid should be used primarily to improve public-sector resource allocation. Equity objectives can be attained through the use of other fiscal tools.

Strengthening State and Local Government

The preceding discussion has demonstrated the need for increasing the internal effectiveness of State and local governments. We can identify three principal areas for Federal assistance: (1) Federal encouragement of, and insistence on, efficiency analysis of State and local proposals for Federal grants; (2) education and training of State and local government administrators in techniques of efficiency analysis; and (3) expenditures on research and development in areas of interest to State and local governments.

Efficiency Analysis

The criterion of efficiency applied to Federal grants to State and local governments is similar to applying Federal money in the manner which will yield the greatest benefit.[2] This criterion is only one of several which could be applied to the allocation of Federal grants. When grants are intended to assist in developing a certain type of program, however, the most useful allocation rule seems to be, give the grant to the project promising the greatest benefits. (Not surprisingly, this criterion is akin to the profit motive for private firms, with the differ-

[2] Benefits may be either predominantly local or predominantly external (i.e., accruing outside the local jurisdiction). Break (*op. cit.*, p. 77), suggests that governments should bear the cost of projects in proportion to the benefits received within their jurisdictions. We consider the distinction between local and external benefits to be of, at most, secondary importance in light of the general underconsumption of public goods, discussed above.

ence that the Federal Government has no self-interest in the allocation.)

The efficiency criterion need not prevent the Federal Government from pursuing noneconomic policy goals. For example, it may be politically desirable to limit the availability of grants to projects which are administered on a nondiscriminatory basis. In view of the difficulties of obtaining equitable resource allocation, some general guidelines of this sort may be unavoidable. We feel, however, that constraints of this sort should be imposed *generally* wherever possible, without reference to specific projects or even to grant applications vis-a-vis other types of State and local projects. Economists recognize that imposing constraints on an allocation mechanism can only reduce the efficiency of the resulting allocation.

If the Federal Government determines that distributional inequities exist, whether they are among States, regions, income groups, or races, the economically proper mechanism for correcting these inequities is direct grants of resources or income to the underprivileged areas or groups. These grants may be received by State or local governments, or by the disadvantaged economic units themselves. (Such grants, however, should be considered part of the overall Federal program of redistribution.) In any case, the distribution of income is not a problem to be confused with the allocation of resources to the most productive uses (i.e., in the most efficient manner).

(1) SUGGESTED PROCEDURE FOR ALLOCATION OF GRANTS

The Federal Government should concern itself not with allocating its revenues to specific types of State and local projects, but instead with delineating broad areas of national concern and allocating totals of funds for grants within these areas. For example, the Federal Government should not earmark grants for school construction, but might instead determine the total Federal commitment for grants in the area of investment in human capital.

Within each broad area thus identified by the Federal Government, individual State and local grant applications then should compete for funds. The allocation of Federal funds should be on a efficiency basis, in that no restrictions should be placed on the type of mix of projects, the area distribution of grants, or the level of recipient governments. The intent of the Federal Government must be to encourage the development and application by States and municipalities of measures of project performance and cost. State and local governments will have adequate incentives to develop efficiency criteria if the Federal Government makes these criteria its basis for allocating grants among competing projects. Moreover, we see no gain, from an efficiency viewpoint, from the policy of issuing Federal grants to States for later distribution to localities.

(2) SPECIFIC PROPOSALS

Two specific suggestions can be derived from the foregoing discussion:

(*a*) The Federal Government should not distinguish between capital grants and operating or current grants within each broad "area

of national interest." Such a distinction is valid in economic terms, since both capital and current costs are included in most programs, although in different proportions. There is no economic reason to penalize capital-intensive projects at the expense of others if the former are more "productive" (in the efficiency sense), especially inasmuch as both capital and current costs involve claims against (substitutable) resources.

There is also a political reason not to differentiate between capital and current grants. Historically, States and localities have tended to receive Federal capital grants, such as for highway construction, with ensuing pressure upon their current budgets to provide funds for operating the federally subsidized capital facilities. Thus, the Federal capital grants have actually increased the claims on States' and localities' operating funds, and consequently have caused misallocation of resources among current projects. In other words Federal grant programs, designed to aid State and local governments, have actually worsened the budget positions of some of these governments.

(*b*) The Federal Government should plan, in its grants policy, to support projects over their expected lifetime of need. While this point sounds self-evident, many existing Federal grants are on a yearly basis although the program being supported was proposed initially for a multiyear period. Of course, this requirement presupposes that grant applications will include reliable estimates of the time-horizon of the project. But the tendency for Federal funds to be used as "seed money," to start a program without expecting to continue it, may be pernicious (especially with respect to social welfare programs in which people's expectations are an important variable).

A qualification to this discussion, however, is that so-called pilot programs, studies of feasibility, should of course be exempted. Pilot programs must be expected to have greater costs than the full-scale programs which they precede. A pilot program may be termed "successful" if it develops or demonstrates the use of techniques which may be applied by other governments to similar problems. For example, a federally assisted urban renewal demonstration project in Washington, D.C. should be judged *not* on the basis of its success in improving neighborhoods in Washington. Rather, the program is successful if St. Louis, San Francisco, and Boston are moved to undertake similar projects *without* Federal support. In evaluating proposals for pilot studies, therefore, the Federal Government should estimate the potential importance of spillovers to other governments, and the likelihood that the proposed study will achieve these spillovers.

Education and Training

Most State legislatures have discovered by now that there exist economies of scale in education. Within limits, the average cost of education declines with an increase in the number of students. Faculty members too recognize the advantages of teaching the same material to many classes. These properties of education suggest that the Federal Government should undertake programs of education and training of State and local government administrators in efficiency analysis.

We should expect education to be undersupplied by States and localities because the comparatively limited demand in one State for

this type of training makes programs quite expensive. Federal support could take two forms: direct operation of training programs, perhaps through extension offices in regions, States, or cities; or contracting to private firms or universities with staffs qualified to give this type of training. Both approaches are now being followed within the Federal Government. At the least, such programs should yield a spillover benefit in improved coordination among administrators at different governmental levels who attend such training institutes and work together on the same problems.

Several types of specific programs may be suggested to improve the level of training in the area of efficiency in State and local governments.

(*a*) Scholarships should be established for graduate education of young economists, political scientists, and administrators interested in State and local problems. Such scholarships would be directly akin to NSF and NDEA fellowships in the natural and social sciences. While such a program would have primarily a long-run impact, it could help focus national attention on problems of the State and local governments. These scholarships would help to provide a talented pool of efficiency analysts, capable of research as well as administration.

(*b*) At present the Federal Government is developing several "midcareer" programs which teach the techniques of efficiency analysis to mid-level and senior Federal agency personnel. These programs, most of which are less than 2 years old, were designed to remedy the shortage of senior officials possessing the skills needed in program budgeting, systems analysis, etc. In some programs, midcareer personnel spend a year away from their jobs, in residence at the educational center, pursuing a full-time course of study which usually leads to a degree. In other programs, shorter, more intensive courses of study are followed. In all cases the Federal agency pays the cost of training its personnel. Since States and municipalities face the same shortage of skilled personnel, similar programs appear desirable for State and local as well as Federal personnel.

It should be noted that individual jurisdictions face a problem in providing this service, since in many cases training of this sort merely increases the marketability of the trainee. States which train personnel only to lose them to higher-paying jobs will be very reluctant to finance their education. The Federal Government cannot solve the problem of greater trainee mobility, but it can at least diminish the States' resistance to training by supporting the program financially.

(*c*) The most important and general training that the Federal Government can support is on-the-job training for State and local administrators. Such training is closely connected with the question of timing the new "efficiency approach" to Federal grants. The first step in this approach is to require a somewhat broader view of programs by State and local officials. As the corollary to a broader Federal evaluative procedure, grant proposals should be required to discuss (1) the basic objectives of the program seeking the grant, (2) spillovers of the program into other jurisdictions, (3) uncertainties surrounding achievement of the objectives, and especially (4) the criteria for evaluating the program.

Research and Development

The past decade has seen the growth of research and development techniques for the analysis of government operations. For the most part, these new techniques of systems analysis, operations research, program budgeting, etc., have received their fullest applications in the Federal Government. However, these methods also are applicable to analyses of operations of other governments.

Applications of operations research techniques to common, mundane problems of State and local government will be of interest to large numbers of jurisdictions. For example, nearly every municipality with public trash collection can profit from an operations-research general computer program for routing trash trucks so as to minimize the cost of a required collection. Many State police chiefs may be able to apply a single study of efficient traffic control.

Similar applications of systems analysis are easy to find. Cities may compare alternative methods of combating juvenile delinquency by applying techniques developed by a pathbreaking study. States undertaking public health programs may compare the value of hospitals, immunization programs, or provision of medical services to rural areas, once basic evaluative methodologies have been developed.

Research into State and local problems may be either "basic," development of new techniques and methodologies, or applications of existing methodologies to new problem areas. In either case, research and development will be useful to many jurisdictions which can specifically apply techniques of efficiency analysis developed for prototype problems. Since research and development work will benefit many jurisdictions, equity considerations require that no one State or locality bear the cost of research. Although States and localities should in theory be willing collectively to support research of the type described, as a practical matter the Federal Government can contribute effectively to State and local government administration by supporting such research.

The Federal Government should undertake two types of programs for research into State and local problems.

(*a*) The Federal Government should undertake research in areas which will have spillovers for many States and localities. The Federal agency made responsible for this research will be required to survey continuously the range of State and local problems, studying some problems itself, adapting some techniques developed by other agencies, and publicizing all such research for the benefit of State and local administration.

The Federal Government should of course confine its studies to problems which are important to State and local governments. To identify these problems, the agency must maintain close liaison with the States and localities, a liaison which may be established most easily by placing interns from State and local governments on the agency staff. Such internships serve the dual function of training the interns, as suggested above.

(*b*) The Federal Government should undertake to support States' and localities' own research in new management techniques. These jurisdictions are at least as able as the Federal Government to identify problems requiring solution, and the Federal Government clearly has

no monopoly on research and development personnel. Consequently, the Federal Government should support State and local governments' attempts to contract out research and development studies to private research organizations such as Rand, management consultant firms, etc.

SUMMARY

The emphasis in this paper has been upon the role of Federal grants in increasing the efficiency of resource allocation within the public sector, viewed as a whole. Our recommendations may be summed up, as follows:

(*a*) The Federal Government should allocate totals of grants to broad areas of national interest. These funds should be awarded to projects offering the greatest total benefits. Secondary considerations such as the ratio of local to external benefits should be ignored by the Federal Government inasmuch as the objective of its grants is to remedy the shortage of public services at the State and local level.

(*b*) States and localities should be allowed to allocate funds, subject only to the test of efficiency. The types of projects undertaken should be those which State and local governments feel to be needed. The Federal Government should influence this allocation to specific projcets as little as possible, and then only by imposing performance requirements (such as nondiscrimination) which apply equally to all projects.

(*c*) Grants should be awarded directly to the sponsoring government. Efficiency can only be reduced by awarding grants to States, for later distribution to local governments.

(*d*) Among our specific proposals are:

—funding projects over their expected lifetime, on a multiyear basis,

—establishing programs for training present and prospective State and local employees in the techniques of efficiency analysis,

—sponsoring both public and private research and development projects related to State and local administration.

The intent of these suggestions is to increase the analytical resources of State and local governments. Increasing emphasis within the Federal Government is being placed upon the efficient allocation of resources. Only through programs such as those we suggest can States and localities join the Federal Government in developing a rational allocation of resources within the entire public sector.

FUNCTIONAL GRANTS-IN-AID*

BY GEORGE F. BREAK

In broadening their horizons far beyond the local community, modern producers and consumers have greatly complicated the fiscal problems of State and local governments. Previous chapters have concentrated on the political and economic risks faced by legislators who seek to raise State and local tax rates and the difficulties governments have had in treating overlapping tax bases equitably. Other problems, of special concern to large metropolitan areas, will be dealt with in chapter V. Here the discussion turns to an important source of relief for harried State and local officials—one that, paradoxically, was created by the same forces that have seriously weakened State and local taxing powers. In the modern world some of the most important local governmental programs generate benefits that accrue to people living in other parts of the country. These spillovers, unless offset by forces to be discussed later, justify Federal aid in the form of functional, matching grants to State and local governments, as well as State aid of the same kind to cities and counties.

These aid programs are discussed in seven main parts. The first deals with the external public benefits that provide the basic rationable for intergovernment action. Though our knowledge of these spillovers is limited, recent economic research has greatly clarified their role in the field of education, the single most important kind of State and local activity. Education is accordingly used as an example to identify the factors that must be considered by intergovernmental policy makers and to illustrate the importance and probable geographical scope of the external benefits that result. The conclusion is that external benefits, which will probably continue to grow in importance, are already pervasive enough to support a strong prima facie case for Federal and State functional grants to lower levels of government.

The nature of this case for functional grants is examined in the second part of the chapter. Decisionmaking at the local governmental level, it is shown, will be influenced not only by the presence of benefit spillouts but also by any benefit spillins or cost spillouts that are related to the program under consideration. Satisfactory choices, therefore, are likely to result only if all of these spillovers are absent or if, being present, they are so well balanced that their opposing effects simply cancel out. In the absence of these rather special circumstances, intergovernmental grants are required both to improve the allocation of resources and to achieve interpersonal equity. The ideal kind of grant for this purpose is described in the third section to provide a basis for the subsequent discussion of existing Federal grant-in-aid programs. The major criticisms of these programs are then presented and

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*Reprinted from Break, George, *Intergovernmental Fiscal Relations in the United States*, The Brookings Institution, Washington, January 1967, Chapter III.

analyzed in the next two sections. Then the wide variety of functions the grant-in-aid programs perform is described, with particular reference to the existence or nonexistence of benefit spillovers. The final section of the chapter stresses the important role that States play as intermediaries for intergovernmental grants and presents a broad statistical picture of the aid they extend to their own local governments.

External Benefits of State and Local Spending Programs

Economists normally distinguish two kinds of benefits that arise from government spending programs: those which flow directly to specific individuals, called private benefits, and those which accrue broadly to the society as a whole, called social benefits. Both of these become external whenever they are enjoyed by persons outside of the government jurisdiction that generated them. When this happens local voters, lacking any financial contribution from outside beneficiaries, are likely to undersupport the programs in question, thereby impairing economic performance by distorting the allocation of resources. The external benefits of State and local expenditures, therefore, should be important elements in any set of policies designed to achieve fiscal equity and efficiency in a federal system.

Public education took 38 percent of State and local general governmental expenditures of $69.3 billion in 1963–64. Education, of course, produces important benefits not only to the individual student and his family throughout his life, but also to many other people who are associated with him in production or consumption or who are simply members of the same economic and political system. It is only the benefits to other people that concern us here, and among them only the ones that accrue outside the school district or State in which the education was received.

Such external educational benefits occur for three reasons. The first is that some of the most important of all educational benefits accrue broadly to everyone in the country. Take the long-recognized relationship between a well-functioning democratic political system and the educational attainment of its citizens. That this relation is a close and important one is generally agreed, and recent empirical research confirms this belief. Voter participation and education are positively related, sometimes to a striking degree. Among males aged less than 34 years and not living in the South, for example, only 60 percent of those with a grade school education voted in the 1952 and 1956 presidential elections, compared to 78 percent of those with a high school, and 88 percent of those with a college education.[1] More comprehensive measures of citizen participation in political activities, based on work done for political organizations, financial contributions to campaigns, attendance at meetings and so forth, show similar results. Meriting a top rating on these tests were 20 percent of grade school graduates, 30 percent of high school graduates, and 45 percent of college graduates.[2] These measures, of course, deal only wih the quantitative dimension of political action, but we may assume that quality also increases with educational level.

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[1] In the South, where restrictions on voting obscure the relationship in which we are interested, comparable figures were 19 percent for grade school, 55 percent for high school, and 81 percent for college educations. See Angus Campbell, Warren Miller, Philip Converse, and Donald Stokes, *The American Voter* (Wiley, 1960), p. 495.

[2] V. O. Key, Jr., *Public Opinion and American Democracy* (Knopf, 1961), pp. 331 and 564–565.

Nor is political participation the only social benefit to be considered. For many people, variety and change, the excitement of new discoveries, the satisfactions from meeting new challenges and from accomplishing undreamed-of things are all part of the good life; and the good life, in this sense, is much more likely to be found in an educated, and particularly a well-educated, society. In general, the more a society is geared to technological advancement and economic growth, the more universal is its need for minimum levels of public education. Those who lack training in the mechanics of learning are often unable to adapt to new conditions of work, and by failing to keep up, these people impede the attainment of the goals society has set for itself. Needless to say, no part of this first class of external educational benefits lends itself to quantitative measurement. It is no less important for that reason, however.

A second group of educational benefits is private in nature, but these accrue to outsiders—people who associate in one way or another with the person who is educated. Knowledge and skills tend to rub off onto fellow workers, and employers can often accomplish more when they are dealing with a trained and literate labor force.[3] Education also has a pervasive effect on the flavor of community life. Families with few, or no, children may support the schools partly to secure a quieter and more responsible neighborhood in which to live and partly in the hope that the cultural and artistic life of the whole community will thereby be improved. One of the attractions of the big city, surely, is the escape it offers from the stultifying atmosphere created by limited intellectual attainments. In the past, there have been so few highly educated and talented people that only the largest cities could contain enough of them to make a difference in community life. In the future, however, more and more of the smaller cities and towns should be able to achieve comparably high cultural and intellectual standards. Education, therefore, may represent an important, long-run solution to the problem of urban congestion (see ch. V). Finally, we must note the important effect of education on governmental expenditures for police and fire protection and for health and welfare services of all kinds. By spending money now to develop a man's talents and interests so that he can support his family and lead a satisfactory life, society can avoid the future costs that are imposed on it by ineffectual and frustrated people.

Benefits of this second kind, which are attached to the educated person himself, become external, in the geographic sense, whenever that person moves away from the area in which he received his schooling. Migration, then, is the force that creates these spillovers, and there is no need to stress its importance in the postwar U.S. economy. About one-fifth of the Nation's population moves each year, and though many of these moves are within the area served by particular local governmental units, a large portion of them undoubtedly are not. The Council of Economic Advisers noted in its last report that ". . . nearly 6.5 million people move across State lines every year,"[4] and a recent study of migration patterns in Clayton, Missouri, a suburb of St. Louis, showed the following results:

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[3] Werner Z. Hirsch, Elbert W. Segelhorst, and Morton J. Marcus, *Spillover of Public Education Costs and Benefits*, Institute of Government and Public Affairs, University of California (1964), pp. 335–341.

[4] *Economic Report of the President* (January 1966), p. 95.

Area	Percent of migrants moving—	
	To Clayton from area	From Clayton to area
Rest of St. Louis County	49½	58
Metropolitan St. Louis	18	8
Rest of Missouri	5	3½
Rest of United States	24½	28½
Rest of world	3	2

On the basis of these and other data the author of the study concluded: "Mobility of the U.S. population is such that the vast majority of financial returns from public elementary and secondary schooling are generally realized outside the school districts which provided the child's education."[5] Many of the educational benefits that are external to the student and his family, therefore, will also be external to the government that educated him.

The third and final kind of external educational benefit results from overlapping units of government. Consider a group of people who, having received a certain amount of additional education, produce during their lifetimes more goods and services and earn higher personal incomes than they otherwise would have. These additional incomes, so long as they are at least equal to the value of the additional goods and services, will, in the absence of government intervention, enable the educated group to purchase for their own use all of the additional output that they create. Modern methods of taxation, however, divert some of the extra buying power to all three levels of government and, through them, redistribute it to other people in all parts of the country. Whether this redistribution takes the form of lower tax rates or higher levels of governmental services or lower terms of credit because the government competes less vigorously for loans is immaterial for the present study. What does matter is that some of the additional output created by education flows, as a result of governmental operations, into the hands of people who live outside the governmental unit of the educated group. The benefits they receive may consequently be classified as external educational benefits.[6]

Education, then, is one state and local government program that generates large amounts of external benefits and disseminates them broadly throughout the entire country. Other public programs have similar benefits though their importance is sometimes more open to question and their scope is often confined to one region. While this study need not undertake a comprehensive analysis of all of these benefits, there are specific questions that, in my opinion, should be asked about any functional grant-in-aid program that purports to serve the national interest.

The questions are three in number:

1. Does the program generate external benefits of at least one of the three types discussed in the case of education?

[5] Burton A. Weisbrod, *External Benefits of Public Education* (Industrial Relations Section, Princeton University, 1964), p. 62.

[6] This conclusion rests on the assumption, which appears reasonable, that better educated people do not counterbalance the extra taxes they pay by additional demands for government services whose benefits accrue entirely to themselves. Additional demands for public goods that generate only social benefits will, of course, benefit others as well as themselves. *Ibid.*, p. 70.

2. Exactly what is the nature of the benefits? Research by economic and political scientists has now reached the point where policymakers can demand more than vague generalities in support of a given activity. They can expect to be told in what specific ways a program operated in one area is likely to benefit other areas—by expanding possibilities of production, by raising consumption and living standards, or by improving the operation of the political system.

3. How important are the benefits? Answering this question requires a combination of rough quantitative measurements and subjective political judgments. All external effects of the kinds discussed earlier should be evaluated on their merits, but many others can be excluded—the purely pecuniary spillovers that merely change the values of existing resources and alter the distribution of a given amount of national income. These distributional effects are ordinarily too insignificant and too thinly spread to be worth including in the evaluation of specific public programs.[7]

These three questions are the basis of the evaluation of existing Federal grant-in-aid programs given in later sections. As a background for that discussion, table III-1 presents a classification of a selected group of government services according to the scope and importance of their external benefits. In the local category are placed programs with few spillovers beyond the jurisdiction of the operating government; the intermediate category contains programs that tend to spread significant benefits over an entire region, such as a metropolitan area or a river valley; and the third class includes activities that appear to have sufficient interstate spillovers to qualify them for Federal grant assistance.

TABLE III-1.—*Classification of selected Government services by the geographical scope of their benefits*

1. Local [1]	Fire protection.
	Police protection.
	Parks and recreation.
	Public libraries.
	Water distribution.
	City streets.
2. Intermediate [2]	Air and water pollution.
	Water supply.
	Parks and recreation.
	Public libraries.
	Sewage and refuse disposal.
	Mass transit.
	Arterial streets and intercity highways.
	Airports.
	Urban planning and renewal.
3. Federal [3]	Education.
	Parks and recreation.
	Aid to low-income groups.
	Communicable disease control.
	Research.

[1] Services with few important benefit spillovers beyond the local level of government.
[2] Services with significant spillovers beyond the local level but not beyond the regional level.
[3] Services with significant spillovers beyond the regional level.

[7] See Roland N. McKean, *Efficiency in Government Through Systems Analysis* (Wiley, 1958), pp. 134–150.

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Several features of the classification, which is admittedly a highly personal one, deserve specific comment at this point.[8]

1. Few, if any, local public services leave outsiders completely unaffected. Poor fire protection along the boundary of one governmental unit may impose extra costs on its neighbors, and good public libraries will attract readers from a whole region and provide educational services of general public significance. The benefits of police protection are probably localized, but in the mobile and technical economy of today they can be realized only with the help of state and federal law enforcement programs.

2. Parks and recreational facilities are difficult to classify because, depending on their nature, they may serve only residents of the immediate neighborhood or they may attract users from much wider areas. The second type of facility need not pose serious financial problems as long as user charges are feasible. Whenever such collections are administratively impractible, however, free benefits will flow to people living in other local jurisdictions or even in other states. Effective programming probably will require various kinds of cooperative intergovernmental planning and financing arrangements. These may involve all municipalities in a given urban area or all state and local governments in a given interstate river basin, and in each case federal stimulus and aid may be needed as a catalyst.

3. That the benefits of a reduction in air pollution typically overlap local and metropolitan boundaries, and often state lines as well, needs no demonstration. On the other hand, there do not appear to be any spillovers to other parts of the country. It is true that manufacturers of smog-control devices may find their income-earning powers enhanced and automobile makers may find their profits reduced, but these are pecuniary spillovers and should be excluded from consideration.

4. The justification for placing education in the federal category has already been given. If included there, it would also carry with it an important group of complementary services, including health care, public housing, and other types of assistance for low-income families with children, as well as the preschool care and training of disadvantaged children. In the absence of these programs, public education could not realize its full potential, and many of its external benefits would consequently never materialize.

5. Probably the most controversial entry in the table is the placement of intercity highways, the single most important federal grant-in-aid program in the intermediate class. Whether high-speed highways should be there or in the Federal class is a moot question. The Advisory Commission on Intergovernmental Relations, for example, attributes "large indirect social benefits" to urban transportation though it does not identify them,[9] but J. M. Buchanan concludes that the spillover effects of interstate high-

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[8] The division of programs between the local and intermediate classes will be discussed more fully in ch. V.

[9] *Performance of Urban Functions: Local and Areawide* (September 1963), p. 263.

ways are relatively insignificant.[10] While nonusers certainly benefit from the highway system in their own part of the country, many of these benefits come to them through commercial transactions—that is, better transportation facilities enable them to obtain a greater variety of goods or to have the same goods at lower prices. This being the case, one may wonder whether their demands would not induce highway users to induce the appropriate State or regional authorities to construct the desired highway facilities. When most program services can be financed by user charges and these charges are passed on to nonuser beneficiaries through the marketplace, there should, in other words, be no need for Federal intervention in the area. Not all highway benefits, of course, fall in that category. Nonusers benefit from highway services in their social relations, and an interstate highway system may contribute to the national defense. It is over the importance of these spillovers that disagreement occurs.

Economic analysis of the external benefits of State and local spending programs is still in its infancy. There is no doubt, however, that these benefit exist, and in a number of important areas they appear to be extensive enough to justify the existence of Federal, functional grants-in-aid. The case that can be made in support of such grants is discussed in the next section.

Program Spillovers and Determining Local Government Spending

The role that benefit and cost spillovers usually play in the choice and extent of local governmental programs may be understood by considering the behavior of a rational voter and then modifying that pattern, insofar as possible, to conform with an imperfect and somewhat irrational world. By "rational voter" I do not mean one who knows all, sees all, and weighs all effects with great care. Information is not a free good; some of it is uncertain and undependable, and the decision-making process takes time and effort. Here the voter is assumed to have adapted himself to this situation by restricting his attention to those program effects that are both important and reasonably certain to occur. He is also assumed to be motivated only by those effects which bear directly on him and on the area in which he lives and works.

The problem, let us suppose, is whether or not a proposed expansion in a local government program should be approved. If there were no spillovers at all, the choice would be simple. The rational voter would compare benefits and costs and reach his decision on the basis of which side outweighed the other. If he included all important social, as well as private, benefit and costs, the choice would be optimal in the economic sense. With spillovers present, however, an optimal choice becomes considerably more difficult. While for society as a whole all incremental gains and losses should be considered,[11] local voters will ignore those which affect outsiders only. Optimality will be threatened, therefore, whenever important external benefits and costs exist and do not cancel out each other's effects. In other words, the fact that educa-

[10] "Federal Expenditure and State Functions," in *Federal Expenditure Policy for Economic Growth and Stability,* Joint Economic Committee, 85th Cong., 1st sess. (1957), p. 178.

[11] For purposes of this discussion, international spillovers may be ignored.

tion has significant external benefits does not necessarily mean that the program will be undersupported by rational voters, since there may be opposing effects that neutralize the distorting influence of the benefit spillovers. These offsets can be of two kinds: benefit spillins and cost spillouts.

As noted in the preceding section, some important educational benefits are shifted about the country by migration. The residents of any given area, therefore, lose to the extent that people they have helped to educate move out but gain to the extent that people who were at least as well educated elsewhere move in. A close balance, qualitative as well as quantitative, between these benefit spillouts and spillins does not, however, guarantee the proper amount of support for local education. Among the gains to be realized from better schools rational local voters will wish to include only those benefit spillins that are in fact induced by their own higher school expenditures, but they will exclude from consideration all benefit spillouts. Support for local schools will consequently be based on the proper stream of educational benefits only if the value of the induced spillins exactly equals the value of all spillouts.[12]

Of course, a superior local school system will attract residents from other parts of the same metropolitan area or even induce businesses to locate plants in one city or State rather than in another. Even so, there are good reasons to suppose that in the great majority of cases local choice will be based on an estimate of educational benefits that is too small.

1. Whereas benefit spillouts can be readily related to known population movements out of the locality in question, induced spillins can be estimated only by a quantitative analysis of human motivation. Better schools are not the only reason that people move, and moreover, higher educational spending in one community may induce higher expenditures in another, so that together they gain fewer new residents than either could have gained in isolation. Because of these uncertainties, benefit spillins may appear to many voters as a minor justification for higher school expenditures.

2. In addition to inducing some benefit spillins, a better education program is likely to increase the rate of outmigration from the community. This is because the propensity to move tends to increase with education level. The following figures illustrate the relationship.[13]

Probability of migrating, 1950, people aged 25 and over

Amount of schooling:	
Less than 5 years	0.036
5 to 8 years	.038
12 years	.053
16 years	.083

[12] If B = the present value of the future benefits (from a given local project) that can be expected to remain in the district,
B_o = the present value of project benefits that will be shifted elsewhere by migration (benefit spillouts), and
B_i = the present value of induced benefit spillins (which will be benefit spillouts to some other locality), then
optimal choice from the national point of view would be based on the total benefit stream of the project in question, which is $B+B_o$, whereas rational choice from the local point of view would be based on $B+B_i$.

[13] Weisbrod, *op. cit.*, p. 48.

These forces, of course, tend to reduce the benefits that will be considered by local voters.

3. Some educational benefits are external because they accrue automatically to outsiders and do not depend on the existence of migration. Consider, by way of example, the improvement in political decisionmaking at the Federal level that might result from increased spending on the part of one school district in the country. Clearly, the gain would be very small indeed unless the one district's action induced similar behavior on the part of many other districts. This is hardly a likely enough possibility to sway a local voter's sympathies toward better schooling. Therefore, some important educational benefits will not be adequately considered at the local level of government.[14]

To many readers benefit spillins and spillouts may appear too esoteric to be taken seriously as factors motivating the average voter. In response, one may cite recurring complaints about "brain drains"[15] and point to statistical studies whose results are consistent with the hypothesis that spillovers do matter. A recent multivariate analysis of 1957 per capita expenditures for police, fire, sewage, sanitation, and recreation in 478 counties with population densities over 100 per square mile, for example, revealed a statistically significant negative correlation between per capita expenditures and the number of governmental jurisdictions operating in a county.[16] These results, in the author's view, imply that benefit spillouts, which are likely to rise in importance as the number of jurisdictions per county increases, tend to keep governmental expenditures per capita lower than they otherwise would be. Similar results were obtained by Burton A. Weisbrod in his study of State-local noncapital expenditures on elementary and secondary education per student in 48 States in 1960.[17] Independent variables measuring each State's net outmigration and net immigration rates between 1950 and 1958 were included, but only outmigration showed a statistically significant relation to educational expenditures, and it was in the expected negative direction. Because these estimates are based on interstate population movements rather than on those from one school district to another, they provide only a crude answer to the question asked. However, along with some other evidence cited by Weisbrod,[18] they do suggest that local attitudes toward education are influenced by benefit spillouts, that spillins are relatively unimportant, and that local support for schools will consequently be inadequate unless some other offsetting force operates. One remaining possibility is a spillout of educational costs sufficient to balance whatever net spillout of benefits is expected.

In theory, a local government can, by carefully selecting the taxes it employs, shift some of the burdens of its spending programs onto

[14] Even at the State level, increased spending for higher education may appear to have only a minimal impact on Federal political processes. It might, of course, have an important effect on governmental operation within the State, but only to the extent that the better educated people remain there, rather than migrating to other States. It may be noted that migration rates appear to be especially sensitive to the effects of higher education. Whereas the probability that a high school graduate aged 25 to 29 would migrate was only 0.085 in 1950, the corresponding probability for a college graduate was 0.165. *Ibid.*

[15] *Ibid.*, p. 102.

[16] Robert F. Adams, "On the Variation in the Consumption of Public Services," *Review of Economic Statistics*, vol. 47 (November 1965), pp. 400–405.

[17] *Op. cit.*, pp. 107–115.

[18] *Ibid.*, pp. 102–106.

outsiders. A tax on hotel and motel rooms is thought to burden the tourist and not the innkeeper, and a tax on business property is said to be paid mainly by consumers, many of whom may come from other governmental jurisdictions. Given these possibilities, it is easy to imagine situations in which local self-interest should produce at least as good public service choices as more enlightened national interests would justify. A loss of 20 percent of the benefits from increased school expenditures through outmigration, for example, would be counterbalanced by the use of a method of financing that imposed 20 percent of the total cost on outsiders.[19] The crucial questions then are: how important are these cost spillouts likely to be in specific instances, and how much influence are they likely to have on voter behavior? [20]

To answer the first question one must determine the incidence of taxation, a subject on which many learned treatises have been written. The results, I fear, are much less impressive than the analysis by which they were derived. Economists are not agreed among themselves about where the burdens of property, sales, and corporate income taxes lie. Though elaborate empirical measurements of the distribution of these burdens continue to be made,[21] the findings are no less arbitrary than the assumptions about tax incidence upon which they depend.

This widespread disagreement among the experts about the location of tax burdens makes it hard to persuade local officials and voters that certain public spending projects will serve their own interests because part of the costs can be shifted elsewhere. It is possible, of course, that local taxpayers think they have greater powers to shift their burdens onto outsiders than economists believe to be the case. Given the human tendency to underplay one's benefits and to overestimate one's costs, however, the weight of taxpayer opinion is likely to be on the other side. School bond issues, for example, are frequently opposed by businessmen even though the higher property taxes they would have to pay to finance the bonds are supposed by economists to be shifted in large part to the consumer. Similarly, sales and excise taxes are seldom viewed by businessmen with the equanimity one would expect from people who simply collect the tax from the consumer and transmit it to the Government.

If this assessment of taxpayer attitudes is realistic, cost spillouts

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[19] If we let

C = the present value of project costs to be borne by local residents, and
C_o = the present value of project costs to be borne by outsiders, then

making use of the symbols defined above in footnote 12, we can contrast the decision-making rules that will be dictated by national, as opposed to local, considerations. Under the socially optimum rule new projects should be undertaken if:

(1) $B+B_o \geqq C+C_o$.

Under a local self-interest rule, on the other hand, new projects would be undertaken if:

(2) $B+B_i \geqq C$.

Pursuit of local interests, therefore, would lead to optimal choices only if:

(3) $B_o-B_i=C_o$. In the absence of this precise balancing of spillover effects local projects would be under- or over-supported according as B_o-B_i exceeds or falls short of C_o.

[20] Cost spillouts from the point of view of one area are, of course, cost spillins from the point of view of another. Spillins are excluded from the analysis in the text on the argument that the inflow of costs from other jurisdictions is mainly, or entirely, independent of the spending decisions made by the local government in question. Induced cost spillins would occur only if spending or taxing decisions in one area motivated some other area to adopt taxes that would be shifted to residents of the first area.

[21] See, for example, Hirsch and others, *Spillover of Public Education Costs and Benefits, op. cit.*

are not likely to play an important role in local evaluations of new Government programs. And even if, contrary to the present argument, voters are not very skeptical of the possibilities of tax shifting and do support higher local spending partly because they expect to escape some of its costs,[22] they may at the same time be less than fully rational in their evaluations of project benefits. They may underestimate benefits because, unlike costs, they are frequently intangible and spread well into the distant future.[23] The more important biases of this sort are, the more existing cost spillouts are needed to offset their distorting influence, and the less, therefore, are cost spillouts available to counteract the distoring effects of benefits spillouts. That job, it would appear, is best left for Federal and State functional grants-in-aid.

Optimizing Grants

Intergovernmental grants designed to minimize the distorting effect of benefit spillouts on the level of State and local spending should have four main qualities. First, they should be categorical or conditional—that is, restricted to State and local programs that do have significant external benefits. Within that group, the size of the grant should increase with the importance of the external benefits of a program. Second, they should be matching grants with both the grantor and the grantee governments sharing in the cost of the supported programs. In principle the grantor's share of program costs should equal the ratio of external benefits to total benefits, but in practice problems of measurement compel the use of only a rough approximation to the ideal. Nevertheless, some reasonable distinctions between programs, and between States under a given program, should be possible. The spillout of benefits from State and local educational programs, for example, is presumably greater for low-income than for high-income areas, since the former typically have the higher rates of outmigration. Such a situation calls for variable matching grants, the grantor government paying a higher share of program costs in the lower income States and localities. Moreover, rates of return on additional educational expenditures are likely to be higher in low-income areas where, even with above-average tax effort, it is difficult to match the program levels reached by more affluent States.[24] If such a combination of above-average returns on additional schooling and above-average levels of tax effort is thought to justify above-average financial support from

[22] It should also be noted that whenever a government uses more than one kind of tax to finance its activities, it is impossible to tell which tax pays for what projects.

[23] See, for example, Anthony Downs, "Why the Government Budget Is Too Small in a Democracy," *World Politics*, vol. 12 (July 1960), p. 541.

[24] Weisbrod, for example, found the rate of return on schooling to be higher in the South than elsewhere (*op. cit.*, p. 134). There is also evidence that the productivity of the earlier stages of education exceeds the productivity of later stages. Thus W. Lee Hansen ("Total and Private Rates of Return to Investment in Schooling," *Journal of Political Economy*, vol. 71 (April 1963), pp. 134–135) estimated the internal rates of return to total resource investment in schooling for U.S. males in 1949 to be 15 percent for elementary school, 11.4 percent for high school, and 10.2 percent for college. These computations, moreover, take no account of the value to the student completing a given level of education of the option he thereby acquires to obtain still more education (see Weisbrod, *op. cit.*, pp. 138–143). Inclusion of these values would raise all three rates of return and increase the differences among them.

higher levels of government, optimizing grants could readily be designed to take both factors into account.[25]

The remaining two characteristics of optimizing grants are more controversial. Th third is that the grantor government, since it is paying for benefits received, is entitled to ask that its funds be used efficiently and to exercise some controls over the grantee's operation of all supported programs. The difficult, of course, is to specify the kinds of control that are justifiable and to assess the risk that the grantor will wish to push the controls beyond their limits, once the program has been initiated. These problems about which opinions differ widely, are discussed in the next section.

The fourth and final distinguishing characteristic of optimizing grants is that they should be open rather than closed end—that is, the grantor should agree to share whatever program costs the grantee wishes to incur and not limit its support to some fixed amount each year. This is desirable because as programs are expanded, external benefits presumably continue as long as internal benefits continue, though not necessarily in some constant relation to each other. If that relation were correctly reflected in the matching requirements of the grant program, self-interest should keep the grantee from overexpanding its activities, since with each program expansion it would continue to pay the full cost of its own benefits.[26] Difficulties of measurement being what they are, however, governments making open-ended grants can be expected to insist on some program controls, and indeed, the danger of excessive interference from above is presumably greater with open-end than with closed-end grants. It is appropriate, therefore, that the discussion in the next section deal with an existing Federal program of the open-end type. Fortunately a recent study by the Advisory Commission on Intergovernmental Relations provides some highly germane evidence.[27]

THE PROBLEM OF CONTROLS

> "What makes me tear my hair in frustration is when you say there are no controls," Mr. Goodell said. "Mr. Goodell, you call it controls. I call it objectives," Mr. Celebrezze replied quietly.—*New York Times* (Saturday, Jan. 23, 1965), p. 9.

This exchange of views between Representative Charles E. Goodell of New York and Anthony J. Celebrezze, Secretary of Health, Education, and Welfare (HEW), illustrates nicely the disagreement that is possible when two people look at the same Federal grant pro-

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[25] Specific methods of doing so are discussed in ch. IV. For closed-end Federal grants, for example, the funds allocated each year to States could vary inversely with per capita personal income and directly with measures of relative tax effort. Variable matching could also be used to make State contributions vary inversely with per capita incomes.

[26] An implicit assumption throughout the discussion in the text has been that for each grant-supported program internal (local or State) benefits are significantly greater than external (State or Federal) benefits. Should the reverse relation prevail in a given case, it would provide a strong reason for shifting the administration of the program either from the local to the State government or from the State to the Federal Government. If this rule were always followed, of course, internal benefits would, by definition, always be more important than external benefits.

[27] *Statutory and Administrative Controls Associated With Federal Grants for Public Assistance* (May 1964).

gram with different theories in mind about the basic role of intergovernmental grants. If the sole purpose is to reduce existing inequalities in the fiscal abilities of different States to support their own programs (see ch. IV), Federal controls are not called for, and to adopt them is to imply, as Mr. Goodell remarked,[28] that the States are not to be trusted to know their own best interests.

The situation is quite the contrary with optimizing grants, however. Since the public benefits to be paid for in this case accrue jointly to the citizens of two different levels of government, the responsibility for the effective operation of the programs should also be shared jointly. Partnership arrangements, to be sure, are not always easy for the participants to live with, but the point is that the modern world is increasingly calling for exactly that kind of approach to the operation of some of the most important governmental activities. With persistence and good will, the difficulties should be surmountable, and the States can, in any case, simply withdraw from any Federal grant-in-aid program that they feel interferes unduly with their own freedom to act. If the needs for fiscal equalization are taken care of by other means, as they should be, no State could plead poverty as a reason for having to accept a grant on terms it didn't like.

This is not to say that the Federal Government never has, and never will, interfere unduly with State and local activities. It is easy to exaggerate the dangers involved, however. As a result of its study of Federal grants for public assistance, for example, the Advisory Commission concluded that "The States have had a much greater voice in shaping their public assistance programs than frequently has been assumed by critics of the Federal role."[29] Their report describes in detail the wide variation that has come to exist in State standards for eligibility and in the amounts of aid provided to each qualified recipient.[30] Table III–2 gives some of the relevant data for our selected group of States. It shows that aid to dependent children in June 1963 ranged from $9 per recipient per month in Mississippi to $47 in New Jersey and Minnesota, and that old-age assistance varied between $35 per recipient per month in Mississippi and $109 in Minnesota.[31] The proportion of aged receiving public assistance, shown in the last column of table III–2, depends in part, of course, on income levels within each State, but it is also related, as the Commission shows, to three of the requirements that States are free to adopt or not, according to their wishes. States that place liens on the public assistance recipients' property or require recovery from their estates, States that require support of the needy aged by their children and other relatives, and States that require local governmental participation in old-age assistance costs all tend to have low recipient rates, though there are, of course, individual exceptions to this rule.[32]

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[28] The occasion for his remarks was congressional consideration of President Johnson's 1965 Message on Education.

[29] *Statutory and Administrative Controls Associated With Federal Grants for Public Assistance*, p. 27.

[30] *Ibid.*, pp. 30–59.

[31] In each case these were the maximum and minimum amounts for all 50 States.

[32] *Ibid.*, pp. 53–56.

TABLE III–2.—*Average monthly public assistance payment per recipient by program, and proportion of people receiving old-age assistance, selected States, June 1963*

State [1]	Average monthly public assistance payments per recipient			Persons aided per 1,000 population age 65 and over
	Families with dependent children	Blind	Old age	
(A)				
Massachusetts	$43	$137	$83	96
(B)				
New York	41	105	87	31
New Jersey	47	86	96	30
Maryland	32	70	72	38
(C)				
Indiana	28	80	76	53
Illinois	44	94	86	62
Wisconsin	44	93	101	74
(D)				
Minnesota	47	115	109	118
Missouri	24	70	66	208
(E)				
Florida	17	67	64	110
Mississippi	9	38	35	383
Tennessee	19	48	48	148
Virginia	24	68	61	42
(F)				
California	44	123	107	170
Colorado	37	101	104	267
Oregon	38	92	84	79

[1] Grouped by geographical area.
Source: Advisory Commission on Intergovernmental Relations, *Statutory and Administrative Controls Associated With Federal Grants for Public Assistance* (May 1964), pp. 48–53.

Open-end grants and detailed Federal controls have not, therefore, gone hand in hand in the public assistance field. The States, unfortunately, have not used their freedom to best advantage. In recent years instances of lax administration and bad management began to receive wide publicity. Congressional concern over the operation of the program mounted, and in 1962 the Senate Committee on Appropriations directed HEW to make a systematic review of Federal Aid to Families with Dependent Children. This survey, the first to be conducted on a nationwide basis under Federal direction and standards, disclosed that "a high percentage of recipients in many States received incorrect payments, and in an even larger number of instances, case records did not indicate that eligibility had ever been properly established." [33] Under these circumstances, it is not surprising that federal requirements that states participate in a system of continuous quality control were tightened. The whole episode provides a good example of the dilemma that is frequently faced by those responsible for Federal grant programs. On the one hand, irresponsible state or local behavior virtually requires the imposition of detailed Federal controls, but, on the other hand, detailed controls cannot readily be adapted to the great variety of conditions prevailing in the different States. The New York State Commissioner of Social Welfare, for example, argued strongly that the new Federal quality control procedures would not accomplish

[33] *Ibid.*, p. 15.

their objectives in his state. He was not, however, successful in persuading HEW to accept his alternative proposals.[34]

Still another problem is that controls that were once justifiable may be continued even though the need for them steadily decreases. An example in the public assistance field is the requirement that the programs be administered by a single State agency. This rule did much to bring order out of chaos in the beginning, but now it may unduly hamper legitmate State efforts to reform their governmental organizations. The Advisory Commission cited the long and fruitless controversy between Oregon and HEW on this subject,[35] and then proceeded to recommend that Federal law be changed to waive the single State agency rule whenever this did not sacrifice any of the program objectives of the Social Security Act.[36] The merits of this particular proposal need not be debated here, but it does emphasize the importance of flexibility in the administration of Federal grant programs and the desirability of regular Congressional reviews of all statutory provisions that may become outdated.

The most frequent criticism of HEW by the state public assistance directors who were consulted during the course of the Advisory Commission's study dealt with what many would regard as inevitable characteristics of the modern world. Directors complained about the large amounts of paperwork required in the administration of the programs, the lengthy and complicated Federal regulations, and the long and involved clearance process through which materials submitted by the States to HEW must go. Whether much can be done to ameliorate these foibles of large-scale organizations is debatable. In any case, HEW is not unaware of the problem, and it did initiate in late 1963 a project, entitled Handbook Simplification and Clarification, which itself is likely to go through a lengthy and complicated process.

As far as Federal controls are concerned, then, designers and managers of functional grant programs face a familiar problem—they cannot live without them, and they find it difficult to live with them. Similar problems have been encountered in other connections, however, and often with very happy results.

OTHER CRITICISMS OF FEDERAL GRANT-IN-AID PROGRAMS

Quite apart from the difficult question of centralized controls, Federal grants-in-aid have not lacked for critics. To some observers there are too many separate programs imposing excessively complex conditions and using unduly complicated allocation formulas. Others claim that the round trip taken by funds from the States to Washington and back again creates inefficiency and waste and impairs the adaptability of programs to changing conditions. Grants have been criticized for misdirecting State and local expenditures, for rigidifying State budgetary procedures, for curtailing local autonomy, for undermining State and local incentives both to spend their funds wisely and to raise enough of them from local sources, and for shifting too many public responsibilities to Washington so that political power is unduly centralized and citizens are prevented from participating actively in the choice and administration of governmental programs.

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[34] *Ibid.*, pp. 74–75.
[35] *Ibid.*, pp. 76–79.
[36] *Ibid.*, pp. 96–97.

This list of complaints is probably less impressive than it appears. It does not constitute a general indictment of grants as an intergovernmental fiscal device, nor does it, for the most part, identify inherent defects which must be balanced against the benefits of individual grant programs. Take, for example, the alleged distortion of the allocation of local funds to different programs. Badly designed grants may do this, but grants that simply finance external benefits will have exactly the opposite effect. Such grants do not shift state and local responsibilities to Washington, but rather lift from local taxpayers the burden of paying for benefits they do not receive. Local funds continue to be raised for local purposes, and local incentives to tax and to spend wisely are in no way weakened. Indeed, when for one reason or another these activities are not well carried out, Federal grants-in-aid provide a vehicle for effective fiscal reform. A larger proportion of Federal funds may be allocated to States making an average, or above average, effort to tax themselves (see ch. IV), and the Kestnbaum Commission's *Report* stressed the higher standards in state and local service and administration that have resulted in the past from the leadership and supervision of Federal grant-in-aid agencies.[37]

It is true, of course, that Federal grants do complicate the planning and administration of the aided programs. To expect complete local autonomy in the management of programs with significant external benefits, however, is to close one's eye to the requirements of the modern economic world. It is a complicated environment in which to operate, and simple procedures, carried out in isolation, no longer yield satisfactory solutions. These remarks should not be taken to imply that federal administrative operations themselves are above suspicious. Government efficiency has to be worked at constantly, and Federal grant programs are no exception to this rule. In his 1957 study of the operation of nine important grant programs, I. M. Labovitz estimated direct administrative expenses to be 1 percent of the amount of grants paid out, with individual programs ranging from one-tenth of 1 percent for public assistance to 11 to 13 percent for low-rent public housing.[38] Interpretation of these figures is difficult in the absence of measures of program output and performance—high administrative expenses may be justified by the high benefits they produce, and low expenses may disguise low productivities—but the Bureau of the Budget has undertaken detailed studies of government productivity which promise future improvements in Federal operating efficiencies.[39]

The rapid postwar growth in the number of federal grant programs,[40] each with its own special features, raises obvious questions

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[37] *Message From the President of the United States Transmitting the Final Report of the Commission on Intergovernmental Relations*, H. Doc. 198, 84th Cong., first sess. (1955), p. 126.

[38] *Federal Expenditures Associated With the Administration of Programs of Grants-in-Aid to State and Local Governments*, Legislative Reference Service, Library of Congress (Apr. 17, 1957). Inclusion of the prorated costs of tax collection and of the General Accounting Office raised average administrative expenses to 1.6 percent of grants paid out.

[39] U.S. Bureau of the Budget, *Measuring Productivity of Federal Government Organizations* (1964).

[40] Counting the number of different grant programs is a game in which each player is likely to come up with a different answer. The Advisory Commission on Intergovernmental Relations, though it excluded a number of programs included on the Treasury Department's official list, showed 60 different programs in existence in fiscal 1962, and 37 of these had been enacted since World War II. See their *The Role of Equalization in Federal Grants* (January 1964), pp. 16 and 89–92. The 87th Congress set up 11 new programs, and the 88th Congress, by almost any test, was even more prolific.

about the need for some consolidation of separate, but related programs and for greater uniformity among those that remain.[41] Reaching agreement on what should be done, however, has proved to be a difficult task. While the first Hoover Commission recommended in 1949 a shift to a system of broad, consolidated grants, the Kestnbaum Commission in 1955 found strong reasons for confining most grants to relatively narrow areas of activity.[42] The major difficulty, it would appear, has been the lack of a widely accepted logical basis on which to judge grant programs, and it is hoped that the theory of optimizing grants, presented earlier, can do something to fill that gap. Once the existence of external benefits from a program has been adopted as the basic economic justification for Federal functional grants, it is easy to set down the broad policy guidelines that should be used. These are: (1) that no program should be established, or continued, unless the activities it supports do generate significant external benefits; and (2) that two different programs, with different allocation and fund-matching formulas, should be set up only if the benefit spillovers involved are demonstrably more important in the one area than in the other. Under this rule existing programs would be consolidated whenever their contributions to the national welfare appeared to be of the same general order of magnitude. Some applications of this test will be suggested in the next section.

The final criticism, listed at the beginning of this section, that needs to be considered is the argument that Federal grants tend to rigidify State and local budgetary procedures. The danger alluded to here is that States will simply match all Federal grant funds that are available without close regard to the merits of the various alternative uses to which their own funds might be put. Once again the validity of this criticism can be determined only by considering the extent to which Federal grants do in fact finance internal, as well as external, program benefits. If they cover only the latter, as a set of optimizing grants would do, the price at which internal benefits can be obtained is not altered by the grants, and hence there should be no distortion of State and local budgeting. If the Federal grants do finance some of the internal benefits of a given program, however, the cost at which the State or local government can obtain those gains is correspondingly lowered, and if that reduction is large enough, budgetary officials can hardly be blamed for assuming that there are no superior uses for their funds.[43]

Distortions are also likely to be minimized if categorical grants are open- rather than closed-end. With the closed-end type there is a maximum amount of Federal money to be obtained, and State officials may be placed under a strong psychological compulsion to qualify for it, even though, to do so, they must divert their own funds from superior uses. Open-end grants, in contrast, set up no artificial goals, and under them there would appear to be less danger that Congress will decide to finance a larger share of total program costs than the

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[41] For a comprehensive analysis of both of these questions see Selma J. Mushkin, "Barriers to a System of Federal Grants-in-Aid," *National Tax Journal*, vol. 13 (September 1960), pp. 193–218.

[42] *Op. cit.*, pp. 193–198.

[43] If internal benefits are to be financed, in other words, there is much to be said for the use of completely unconditional grants. See the discussion of these in ch. IV.

relative importance of external benefits justifies. Having decided to limit the amount of its annual contribution, in other words. Congress may then be tempted to be lenient with regard to the maching requirements it imposes on the grantee government. Finally, there is the point, discussed earlier, that whenever marginal external benefits exist, Federal contributions should not be limited by a closed-end arrangement if optimal decisionmaking at the state and local level is to be attained.

Functional grants, it is clear, must be designed with skill and care. The gains to be obtained from such effort, however, are great, and their importance is likely to increase in the future. In the tightly integrated society, where the effects of actions taken in one locality or State radiate widely, a premium is placed on effective fiscal cooperation among all levels of governments, and Federal conditional grants are an important instrument for that purpose. It is not surprising, therefore, that the postwar period has witnessed a rapid growth in their use. As a result, the country now has an important set of programs, serving a wide variety of purposes. What these purposes are, how much Federal money they currently require, and what specific external program benefits they seem to cover are all considered in the next section.

Federal Grants-in-Aid in 1964

In fiscal 1964 Federal grants-in-aid amounted to $10 billion, a figure which was 8 percent of Federal, and nearly 20 percent of State and local, cash payments to the public in that year.[44] Though a great variety of programs were included, those for highways and public assistance alone accounted for nearly two-thirds of the total. In this section an attempt is made to group the programs according to the nature and extent of the national interest they serve. This is difficult because of the intangibility of many of the external benefits in question and because of the propensity of Federal grant programs to fulfill more than one purpose. The grants, therefore, must be classified according to their major function, and on this score there is certainly room for differences of opinion.

In the table which follows (based on tables III–3 through III–8) six different groups of Federal grant-in-aid expenditures in fiscal 1964 have been used: education and research, aid to low-income families, health, resource development and recreation, transportation, and functions for which the Federal Government itself has primary responsibility:

Program group:	*Millions*
Education and research	$755
Aid to low-income families	3, 677
Health	692
Resource development and recreation	326
Transportation	3, 672
Primary Federal responsibility	845
Total	9, 967

[44] The grant-in-aid total is from *The Budget of the United States Government, Fiscal Year Ending June 30, 1966*, pp. 467–471, and cash payments to the public are from the *Economic Report of the President* (January 1965), p. 261. State and local cash payments exclude Federal grants-in-aid, as well as contributions for social insurance.

TABLE III-3.—*Federal grant-in aid programs for education and research, actual 1964 and estimated 1966* [1]

[Dollar amounts in millions]

Program	Year enacted	Federal expenditures	
		Actual, 1964	Estimated, 1966
Schools in federally affected areas	1950	$323	$358
Vocational education	1917 1963(E)	41	182
Manpower development and training	1962	80	125
Vocational rehabilitation	1920(E) 1954	88	123
Construction of higher education facilities	1963(E)		109
National Defense Education Act	1958(E)	84	104
Cooperative agricultural extension work	1914	77	83
Agricultural experiment stations	1887 1963	40	51
Rural library services	1956(E)	7	37
Others [2]		15	29
Total		755	1,201
New proposals:			
Elementary and secondary education			495
Manpower development and training			67
Others [3]			15

[1] (E) Program incorporates equalizing factor to determine allocations and/or matching requirements for States.
[2] Land-grant colleges (1862; 1890), educational television (1962), water resources research (1964), teaching materials for the blind (1879), and special training for teachers of the handicapped (1963).
[3] Vocational rehabilitation, civil rights education, and higher education.

Source: United States Budget, fiscal 1966.

The first three of these are closely interrelated because they all contribute to the development of the nation's human resources, and it is indicative of current concern over this important source of economic growth that most of the program increases projected for fiscal 1966 fall in those three areas. To highlight these prospects, figures for both fiscal 1964 and 1966 are shown in the detailed tables (III-3 through III-8): existing programs are ranked by their projected 1966 levels; and estimates for the new programs to be proposed to Congress are included at the bottom of each table.[45] Finally, as a background for the discussion in the next chapter, those programs that incorporate an equalizing factor in the formulas used to determine fund allocations and/or State matching requirements are distinguished by an (E) written immediately after the year in which they were enacted.

[45] The 1967 Budget, which came out after this section was written, projects major increases over the 1966 estimates in three general areas:
1. Educational aids are to rise, mainly because of estimated grant expenditures of $1,200 million for elementary and secondary schools, $204 million for vocational education, $197 million for higher education, and $51 million for libraries.
2. Economic opportunity programs are expected to rise to $1.1 billion in 1967.
3. Grants for housing and community development are projected to rise from $688 million in 1966 to $878 million in 1967.
On the other hand, significant decreases are expected in 1967 grant expenditures for accelerated public works (only $8 million in 1967), schools in federally affected areas ($252 million in 1967), and medical assistance for the aged ($289 million in 1967).
Total Federal grants-in-aid, which were $10.7 billion in 1965, are projected to rise to $14.6 billion in 1967. See *Special Analyses of the United States Budget, 1967,* pp. 134–143.

EDUCATION AND RESEARCH

> Increased Federal support for education is vital because of the crucial role of educated talent in our free society. Each individual must have an opportunity for education to the maximum of his capabilities to fulfill his own potential and to be prepared to work in an increasingly complex economy.—*United States Budget, Fiscal 1966*, p. 123.

Until quite recently well over half of all Federal grants-in-aid for education were made under a program—assistance for schools in federally affected areas—whose main purpose was not to expand educational services but rather to reimburse local governments for fiscal burdens placed on them by Federal Government operations.

The 88th Congress, however, may have set the stage for an expanding Federal role in this area. Called by President Johnson the "Education Congress," it inaugurated grants for the construction of higher education facilities, greatly expanded the vocational education program, and either began or increased Federal support for research at agricultural experiment stations, at State institutes for the development of water resources and fisheries, and at local centers for the study of mental retardation. Table III–3 shows that these and other existing educational grants are expected to expand by nearly 60 percent between fiscal 1964 and 1966. In addition, the 89th Congress in its first session both increased Federal aid to colleges and broke precedent by authorizing a 3-year program of grants to school districts with large numbers of children from low-income families. The benefit spillovers of State and local schools, universities, vocational educational centers, and research institutions have clearly moved more firmly into the center of national attention.

ASSISTANCE FOR LOW-INCOME FAMILIES

> The Economic Opportunity Act of 1964 launched the unprecedented national effort to combat poverty in the United States. The objective of this effort is to break the vicious circle in which one generation's ignorance, disease, and poverty are transmitted to the next.—*United States Budget, Fiscal 1966*, p. 118.

Federal grant programs to aid low-income families have been established in two concentrated waves, the first in 1933–37 in response to the Great Depression and the second in 1962–64 in response to the persistence of high unemployment rates in the midst of national affluence and to the increasing demands on human capabilities of an automated and technological economy. In fiscal 1964 public welfare grants amounted to nearly $3.7 billion and were expected to increase by one-third, to $4.9 billion in 1966. It should be stressed, however, that these figures do not represent the total amount of Federal grant aid going to low-income families. The Manpower Development and Training program, included earlier under Education, and several of the health programs to be considered later also make important contributions.

Federal participation in this area may be justified on ethical and humanitarian grounds—namely, that no family in any part of the country should be allowed to fall below some minimum subsistence level of income. On this basis, the programs are likely to generate more argument about what constitutes an appropriate minimum income level and what the effects on work incentives might be than

about whether the Federal or the State and local governments should shoulder the main responsibility. The economic justification for anti-poverty programs, on the other hand, tends to reverse the emphasis. Effective development of human abilities and incentives clearly requires expanded and integrated governmental support for education, family welfare, and health. Seen in this light, the gains become more concrete, but their geographical distribution is less easily specified. In effect, income-support and health programs operate in conjunction with education and training programs to produce a single set of public benefits, and these are subject to the same spillover effects that were discussed earlier for education. Not all of the public welfare grants listed in table III–4, however, contribute equally to this set of economic gains. The Economic Opportunity Act of 1964 was, of course, specifically designed for that purpose, but neither Old-Age Assistance nor Medical Assistance for the Aged adds materially to the productivity of the labor force. Those who place economic growth above income redistribution as a national goal would favor fewer Federal grants for the aged and more for the support of families with dependent children and for the development of work-training projects.

TABLE III–4.—*Federal grant-in-aid programs in support of low-income families, actual, 1964, and estimated, 1966* [1]

[Dollar amounts in millions]

Program	Year enacted	Federal expenditures	
		Actual, 1964	Estimated, 1966
Public assistance [2]		$2,944	$3,242
Old-age assistance	1935(E)	1,390	1,404
Aid to families with dependent children	1935(E)	1,011	1,126
Medical assistance for the aged	1960(E)	209	351
Aid to permanently and totally disabled	1950(E)	280	329
Aid to the blind	1935(E)	52	52
Economic Opportunity Act	1964(E)		854
Food stamp and donation of surplus agricultural commodities	1961 1933	510	497
Low-rent public housing	1937	183	224
Disaster relief [3]	1950(E)	29	84
Area redevelopment program	1961(E)	11	11
Low-rent rural housing	1964		2
Total		3,677	4,914
New proposals:			
Public assistance			114
Area redevelopment			35

[1] (E) Program incorporates equalizing factor to determine allocations and/or matching requirements for States.
[2] Figures for the individual programs are for obligations and do not add to the total expenditure figures given at the top of this table and included in the grand total.
[3] Includes special 1964 programs for earthquake and flood assistance to Alaska and California, respectively

Source: *United States Budget and Budget Appendix, Fiscal 1966.*

HEALTH

In 1787 Thomas Jefferson wrote that "without health there is no happiness. An attention to health, then, should take the place of every other object."—President Johnson's Special Message to Congress on the National Health Program, *New York Times*, January 8, 1965.

The list of Federal grants for health in table III–5 is deceptively short, for several of the categories shown contain a number of separate programs, each with its own distinctive apportionment formula.

Under Community Health, for example, fall programs for the control of tuberculosis, cancer, heart disease, venereal disease; support for health services for the chronically ill and aged; and grants to finance public health activities with the most obvious spillover benefits of all, the control of communicable diseases. Environmental health deals with such modern-day dangers as air and water pollution and radiation sickness and disease.[46] In many of these programs two different types of grant are used. "Formula grants" are allotted to the States, usually on the basis of both need and fiscal capacity, to carry out State plans that have received Federal approval. "Project grants" are awarded on the basis of specific applications and are typically used to finance research, training, or demonstrations of new techniques. In several cases technical assistance by Federal personnel may be substituted for the more usual cash payment, and project grants are frequently given in health fields, such as diabetes and arthritis control, for which formula grants are not available. In these ways a notable degree of flexibility has been achieved.

TABLE III-5.—*Federal grant-in-aid programs for health, actual 1964 and estimated 1966* [1]

Program	Year enacted	Federal expenditures	
		Actual, 1964 (millions)	Estimated, 1966 (millions)
School lunch and special milk	[2] 1946 [2] 1954	$276	$300
Hospital and medical facilities construction	[2] 1946	187	218
Maternal and child health and welfare	[2] 1935	84	139
Community health	(3)	60	97
Waste treatment works construction	[2] 1956	66	80
Environmental health	(3)	7	14
Other [4]		12	27
Total		692	875
New proposals:			
Maternal and child health			25
Community health			2

[1] Equalizing factor to determine allocations and/or matching requirements for States.
[2] Equalizing factor.
[3] Various.
[4] Includes operating and mental health grants of the National Institutes of Health and miscellaneous grants to Indians, Alaska, and Hawaii.

Source: U.S. Budget, fiscal 1966.

Federal grants for public health may be justified on a number of bases. The Kestnbaum Commission *Report* recognized national responsibility for research, the dissemination of information, and the promotion of minimum standards of public health operations.[47] Communicable disease has already been mentioned. Disadvantaged children obviously need to be healthy and to know how to remain that way if they are to benefit from education and become productive workers. Comparing the amounts spent in fiscal 1964 for health and education grants ($1.4 billion) with the amount spent for public welfare ($3.7

[46] For a concise description of these programs, as they existed in fiscal 1964, see *Catalog of Federal Aids to State and Local Governments,* prepared by the Legislative Reference Service for the Senate Committee on Government Operations, 88th Cong., second sess. (1964), pp. 57–66.
[47] *Op. cit.,* pp. 251–252.

billion), tempts one to wonder if more had been done earlier in the first two areas, less would now be needed for the third—which until the passage of the Economic Opportunity Act was largely a holding operation. Be that as it may, increasing attention is being paid to resource development, including some of the more esoteric forms included in the next category of Federal grants.

RESOURCE DEVELOPMENT AND RECREATION

America owes her greatness partly to the large public and private investments made to develop her abundant natural resources. Rapid growth and urbanization require intensified efforts to solve old problems and imaginative approaches to new challenges.—*Economic Report of the President, January 1965*, page 18.

The conservation of natural resources is a problem that required little attention in this country until quite recently. As table III–6 indicates, it was not until 1911 that the first Federal grant program for this purpose was enacted, to protect the Nation's forests by preventing fires, reforesting denuded areas, and encouraging good management of woodlands. Later in this century, however, it became increasingly clear that blight was not a monopoly of the rural areas. Urban slums with their heavy demands on public services, their meager contribution to public revenue, and their obvious waste of valuable resources elicited more and more concern. Though the elimination of slums promised benefits that would accrue mainly to people in each separate metropolitan area, obtaining the necessary funds from that same area was no easy problem. Central cities lacked access to the tax bases of the suburbs and were kept from raising their own tax rates by fear of losing business and residents. Frequently cities found the rural-dominated State legislatures unsympathetic to their plight.

TABLE III–6.—*Federal grant-in-aid programs for resource development and recreation, actual 1964 and estimated 1966*

Program	Year enacted	Federal expenditures	
		Actual, 1964 (millions)	Estimated, 1966 (millions)
Urban renewal	1949	$212	$329
Watershed protection and flood prevention	1954	57	62
Recreation planning and land acquisition	1964		33
Fish and wildlife restoration	1937 1950	20	22
Open space land	1961	5	17
Urban planning assistance	1954	16	17
Forest protection and utilization	1911 1940 1956	16	16
Community development training	1964		6
Total		326	502

Source: U.S. Budget: fiscal 1966.

The one remaining source of support was the Federal Government, and in 1949 the urban renewal program—now rapidly leaving the $250 million a year level of operations behind—was born. Many people have lamented this direct fiscal relation between national and local governments, but few have done much to solve the political problems that

gave rise to it. In its wake have come grants for urban planning (1954), for the preservation of open-space land (1961), for the development of mass transportation plans (1961) and facilities (1964), and for construction of essential water and sewer facilities (1965).

Earlier in this chapter it was noted that benefit spillovers of parks and the other public recreational facilities, when they exist, can frequently be handled effectively by means of user charges. For this reason primary responsibilities in this area remain with the State and local governments, but the Federal Government does have several important functions. Whenever the facilities to be developed will serve vacationers from many States and user charges are not feasible, the Federal Government is the only public body with sufficient interest in the results to justify the necessary expenditures. Forest and mountain trails and President Johnson's proposed national wild rivers system [48] are examples of this kind of project. Even when user charges can be employed, Federal leadership and coordination is likely to be needed to develop recreation areas that straddle State boundaries. Finally, there is a strong possibility that States, with their continuous preoccupation with shortrun financing problems will undervalue, or even ignore, the future benefits to an ever-growing population of a widespread system of public parks and wilderness areas. From its position of greater fiscal affluence, the Federal Government is in a better position to judge these matters and to finance the necessary land acquisitions before it is too late.

TRANSPORTATION

> If the United States is to maintain and advance its productive and defensive strength, which depend so largely upon the efficiency and economy of the transportation system, an acceleration of the rate of highway improvement is needed, particularly with respect to major highways.—Kestnbaum Report, page 215.

Few Government Commissions, particularly those dealing with Federal-State-local fiscal relations, have seen their recommendations put into effect so rapidly and so massively as the Kestnbaum Commission's proposals for an acceleration of highway expenditures. When it submitted its report to the President in mid-1955, Federal aid authorization for highways for each of the next 2 fiscal years stood at $875 million. Little more than a year later construction of the 41,000-mile, $46.8 billion National Interstate and Defense Highway System was approved, and highway grants expanded steadily, reaching $3.6 billion in fiscal 1964 (table III–7). Among grant programs, the Interstate Highway System is distinguished by the high proportion of costs financed by the Federal Government (90 to 95 percent) [49] and by the fact that these costs are met from earmarked taxes on motor fuels, tires and tubes, and other products purchased by highway users. The program consequently is free of the usual appropriation controls, and since it clearly finances a large share of intrastate highway benefits, it

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[48] See his Message to Congress on Natural Beauty, *New York Times*, Feb. 9, 1965.

[49] Costs of constructing primary, secondary, and urban extension highways, in contrast, are shared equally between the States and the Federal Government.

is likely to divert State funds from superior uses. Whether the program as a whole is justified is not at issue here, but it does illustrate some of the features which many experts find objectionable about Federal grant-in-aid programs. It is one of the fiscal ironies that it was established by an administration dedicated to a strengthening of State and local government responsibilities.

TABLE III-7.—*Federal grant-in-aid programs for transportation, actual 1964 and estimated 1966*

Program	Year enacted	Federal expenditures	
		Actual, 1964 (millions)	Estimated, 1966 (millions)
Federal-aid highway	1916		
	1956	$3,607	$3,822
Airport construction	1946	65	60
Urban transportation assistance	1964		40
Total		3,672	3,922

Source: U.S. Budget fiscal 1966.

OTHER FEDERAL GRANTS-IN-AID

All of the remaining grant programs deal with such primary national responsibilities as unemployment, civil defense, roads and highways on or near Federal lands, and aid to territories, new States, Indians, and the District of Columbia. To a large extent, therefore, they represent a decentralization of Federal operations in the interest of flexibility and administrative simplicity and need not be discussed here. Table III-8 lists the programs involved.

TABLE III-8.—*Federal grants in areas of primary Federal responsibility, actual 1964 and estimated 1966*

Program	Federal expenditures	
	Actual, 1964 (millions)	Estimated, 1966 (millions)
Administration of employment security programs	$405	$502
Public works acceleration in redevelopment and substantial unemployment areas	257	145
District of Columbia	38	52
Forest and public lands highways	37	40
Grants to territories and Alaska	51	34
Civil defense	20	27
National Guard and State and local planning for national emergencies	14	9
Bureau of Indian Affairs	9	11
Veterans' Administration: Aid to State homes	8	9
Miscellaneous	6	8
Total	845	837

Source: U.S. Budget, fiscal 1966.

THE STATES—INTERMEDIARIES FOR INTERGOVERNMENTAL AID

State governments are both major recipients and major dispensers of intergovernmental fiscal aid. In fiscal 1964, for example, they re-

ceived $9 billion from the Federal Government and paid out $13 billion to their own local units.[50] The $13 billion dispensed by the States is a significant figure—35 percent of all State general expenditures and 29 percent of all local government general revenues. While both of these percentages have been remarkably stable during the last 15 years, they now stand well above the levels prevailing during the first three decades of the present century (table III–9). In 1902, for example, State intergovernmental expenditures were only 28 percent of total State general expenditures and 6 percent of total local general revenues.

TABLE III–9.—*State intergovernmental expenditure, amounts and fiscal importance, selected years, 1902–64*

Year	Amount (millions)	Percent of total State general expenditure	Percent of total local general revenue
1902	$52	28.0	6.1
1913	91	23.5	5.6
1922	312	23.2	8.1
1932	801	29.0	14.1
1942	1,780	39.1	25.0
1948	3,283	34.7	28.9
1953	5,384	36.7	29.3
1958	8,089	34.4	29.2
1963	11,885	34.6	28.8
1964	12,968	34.8	29.2

Sources: U.S. Bureau of the Census, State Payments to Local Governments, Census of Governments, 1962, Vol. VI, No. 2, p. 9; Governmental Finances in 1963, pp. 22-24; and Governmental Finances in 1963-64, pp. 22-23.

State aid to local governments has developed partly in response to specific economic emergencies, such as the Great Depression, and partly in response to the long-run forces, discussed earlier, which make for a more mobile and closely integrated economy. With each decade more and more of the benefits from local programs have spread beyond the boundaries of the enacting government, and local tax administration has become increasingly difficult and costly. One possible solution was to move both spending programs and tax collection to the State level, decentralizing State operations whenever this promised administrative economies. The other solution was to leave the programs in local hands, with the hope that this would stimulate greater citizen participation in their operation, but to supplement their financing with State aid. That the latter alternative has been widely adopted is clear from table III–9.

Though some State aid is unrestricted as to purpose, most of it is earmarked for education, highways, and public welfare, and local

[50] U.S. Bureau of the Census, *Compendium of State Government Finances in 1964*, pp. 6–7. As defined by the Census Bureau, intergovernmental aid includes grants-in-aid, shared taxes, payments in lieu of taxes, and payments for services performed on a reimbursement or cost-sharing basis by the recipient government (*Ibid.*, p. 56). Such aid is measured both as intergovernmental expenditure by the payor and as intergovernmental revenue to the payee, but differences in timing prevent the two from being exactly equal for any given year. A grant made toward the end of the year may not be recorded by the recipient until the next year, and whenever the fiscal years used by the two governments involved do not exactly coincide, even grants recorded by both in the same calendar month can be allocated to different fiscal years. In 1963–64, for example, State intergovernmental expenditures to local governments were $12,968 million (the figure used in the text) whereas local intergovernmental revenues from States were reported as $12,873 million. See U.S. Bureau of the Census, *Governmental Finances in 1963–64*, pp. 22–23.

expenditures in all three areas are relatively less important now than they were in earlier years. In 1962, for example, State aid covered 37 percent of total local expenditures for education, 36 percent of local expenditures for highways, and 70 percent of local expenditures for public welfare (table III-10). At the beginning of the century highways and welfare received almost no State support, and local schools were less than 20 percent State financed. In regard to the structure of State aid itself, several changes are worth noting. As table III-11 shows, highway assistance increased rapidly in relative importance after the introduction of the automobile, as did public welfare grants during the Great Depression, and education recovered some of its former predominance after World War II, probably in response to the rapid increase in the school population. Unrestricted State aid, in contrast, began and ended the period covered in roughly the same relative position, about 10 percent of State intergovernmental expenditures in both 1902 and 1962.

TABLE III-10.—*State intergovernmental expenditures for selected functions as a percent of lcal general expenditures for the same functions, selected years, 1902–62*

Function	1902	1913	1922	1932	1942	1952	1962
Education	19	16	13	20	36	37	37
Highways	1	1	7	25	49	34	36
Public welfare			5	8	56	70	70

Source: U.S. Bureau of the Census, *State Payments to Local Governments*, p. 9.

TABLE III-11.—*State intergovernmental expenditures by function, selected years 1902–62*

Function	Percent distribution by years						
	1902	1913	1922	1932	1942	1952	1962
General local government support	10	6	11	17	13	11	8
Education	86	90	65	50	44	50	59
Highways	4	4	22	29	19	14	12
Public welfare			1	3	22	19	16
Other				1	2	5	4

Source: U.S. Bureau of the Census, *State Payments to Local Governments*, p. 9.

The fiscal effects of State aid to local governments may be classified into six basic patterns. Taking first the reactions at each level of government separately, there are the following possibilities:

L1. Local taxes lower, local expenditures (including State grants) unchanged;

L2. Local taxes unchanged, local expenditures higher;

L3. Both local taxes and local expenditures higher;

S1. State taxes higher, State nongrant expenditures unchanged;

S2. State taxes unchanged, State nongrant expenditures lower.

These possibilities in turn may be combined into the six basic patterns:

L1S1. *Tax Substitution.* State taxes have been substituted for local taxes with no change in State or local spending programs.

L2S2. *Expenditure Substitution.* Tax programs are unchanged but local spending has been substituted for State spending.

L1S2. *Expenditure Reduction.* Both local taxes and State nongrant expenditures are lower, while State taxes and local spending programs remain the same.

L2S1. *Expenditure Expansion.* Higher local expenditures are financed by higher State taxes, local taxes and State nongrant expenditures remaining unchanged.

L3S1 and L3S2. *Increased Local Tax Effort.* Here State grants induce an increase in locally financed governmental activities.[51]

In practice, of course, elements from several of these patterns are likely to be combined, the precise outcome depending, among numerous other factors, on the type of State aid given. Though empirical research in this area is still in its infancy, two recent studies do illuminate some important parts of this complex fiscal picture. The first, which involved a multivariate, linear regression analysis of State and local expenditures in 1960, showed State aid to be positively correlated with these expenditures and yielded the following estimates of the additional amounts of per capita State-local expenditures of various kinds that were associated, on the average, with an extra dollar of per capita State aid:

Total direct general expenditures	$0.90–$1.34
Highways	.67
Welfare	.20
Health and hospitals	2.53–2.78
Local schools	[1].52

[1] Seymour Sacks and Robert Harris, "The Determinants of State and Local Government Expenditures and Intergovernmental Flows of Funds," *National Tax Journal*, vol. 17 (March 1964), p. 83. Only the net regression coefficients that were statistically significant at the .05 level have been given in the text.

In all categories, therefore, elements of the *expenditure expansion* pattern (L2S1) appear to be present, but in some cases they were presumably combined with tax or expenditure substitution [52] and in other cases, with higher levels of local tax effort.

The second study, which dealt with the influence of State aid on school expenditures in some 1,400 New England towns and cities in 1961–62,[53] found that the relationship varied significantly between small and large urban areas. While in the former, an additional dollar of State aid per pupil was associated with an increase in expenditures per pupil of between 40 and 80 cents, in the latter, State aid had no discernible impact on school expenditures.[54] As far as statewide averages were concerned, lower local tax burdens emerged as the main fiscal effect.[55] In part this result may be attributable to the relative importance, among New England school aids, of State support for a minimum, or foundation, educational program. Once a school district has achieved that level of operation, State foundation aid provides no direct incentive for it to go further, since all additional costs must be

[51] For simplicity these patterns assume that local nontax revenues, such as licenses, fees, and user charges, are not affected by State-local grant programs.

[52] It should be stressed that a regression coefficient of less than $1 for a specific grant-aided program may underestimate the total amount of induced local expenditure expansion, since the local funds released by the grant may be used to increase expenditures on some other program, rather than to reduce tax rates.

[53] George A. Bishop, "Stimulative Versus Substitutive Effects of State School Aid in New England," *National Tax Journal*, vol. 17 (June 1964), pp. 133–143.

[54] *Ibid.*, p. 139. To identify large urban areas the census definition of a Standard Metropolitan Statistical Area was used.

[55] Bishop interprets this to mean a substitution of State for local taxes (pattern L1S1). Since his study dealt only with local expenditure, however, he was able to distinguish only between lower local taxes (L1) and higher local spending (L2), and his results are consequently consistent with both the *tax substitution* (L1S1) and the *expenditure reduction* (L1S2) patterns.

borne locally.[56] As Bishop notes, school aid in New York State is relatively more important, and is granted in more stimulative forms than it is in New England, and a recent study of New York State aid showed it to be highly effective in raising school expenditures.[57]

Another fiscal distinction of some importance is that between shared taxes and grants-in-aid. The former provide most of the unrestricted aid given to local governments, and shared-tax aid, by its very nature, has some automatic sensitivity both to short-run economic fluctuations and to long-run economic growth. This can vary substantially depending upon the type of tax involved. Netzer's estimates of the long-term GNP elasticity of different tax bases, for example, range from 0.50 for alcoholic beverage excises to 1.70 for the personal income tax.[58] Individual States also differ greatly in the extent to which they engage in tax sharing with local governments. In 1962, for example, New Jersey distributed only $2 million that way, out of total State intergovernmental expenditures of $198 million, whereas in Wisconsin shared taxes were 44 percent of total State aid of $335 million.[59] Wisconsin also illustrates well the variety of sharing arrangements that are used: $67 million from high-elasticity corporate and individual income taxes were returned in 1962 to the local governments of origin; $6 million from the low-elasticity alcoholic beverage sales tax were allocated on the basis of population for general local purposes; and $36 million of highway user revenues were transferred to towns, cities, and counties for road construction. Both shared taxes and State grants in Wisconsin tend to be related to population density, though in opposite ways. According to a 1957 study by Alan H. Smith, shared taxes favored the large cities and were important enough to offset roughly the biased allocation of grants to rural areas.[60] Similar distributional patterns in other States, however, would not be likely to produce such a balanced outcome.

As noted earlier, in the country as a whole State aid now goes mainly for education, highways, and public welfare, but there are significant differences among the States. As table III–12 shows, highway aid ranges from none at all in three States to a high of $17 per capita in Wisconsin, and though 17 States distributed no public welfare grants, Colorado provided $39 per capita, nearly four times the national average. School grants, which were provided by all States in 1962, showed the widest range of all, from 3 cents per capita in Hawaii to $79 in New Mexico. A low level of State aid for a given function, however, does not necessarily imply a low level of State financial support for that activity, as table III–13 shows. Both Hawaii and New Hampshire make few education grants, but the centralized Hawaiian school system is largely State financed. New Mexico and New Hampshire provided a quite different picture. School expenditures were made almost

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[56] Foundation aid does, however, raise the fiscal well-being of each school district, and this change may itself stimulate higher school expenditure.

[57] *Ibid.*, p. 133, and Seymour Sacks, Robert Harris, and John J. Carroll, *The State and Local Government . . . The Role of State Aid*, New York State Comptroller's Studies in Local Finance, No. 3 (1963). Their estimate was that an additional dollar of State aid per capita tended to raise per capita school expenditures by 90 cents.

[58] Dick Netzer, "Financial Needs and Resources over the Next Decade: State and Local Governments," *Public Finances: Needs, Sources and Utilization* (National Bureau of Economic Research, 1961), p. 30. The estimates are for the period 1957–70.

[59] U.S. Bureau of the Census, *State Payments to Local Governments*, pp. 70–71 and 105–107.

[60] "State Payments to Local Governments in Wisconsin," *National Tax Journal*, vol. 15 (September 1962), pp. 297–307. The study was based on data made available in the 1957 Census of Governments.

entirely at the local level in each, but New Hampshire provided little State aid and ranked 49th among the States in the amount of its school expenditures per $1,000 of State personal income, and New Mexico ranked first both in the amount of State school aid per capita and in the amount it spent for local schools in relation to its income.

TABLE III-12.—*Range of per capita State intergovernmental expenditures, by selected programs, 1962*

Function	Average for all 50 States	Highest amount	Lowest amount or number of States not providing
Total State aid	$59	California, $97	New Hampshire, $11.
General support of local government	5	Hawaii, $27	6 States.
Education	35	New Mexico, $79	Hawaii.[1]
Highways	7	Wisconsin, $17	3 States.
Public welfare	10	Colorado, $39	17 States.

[1] Less than $0.50.

Source: U.S. Bureau of the Census, "State Payments to Local Governments," p. 12.

TABLE III-13.—*State grants and State support of local schools, 1962*

State	State grants for education (millions)	Noncapital expenditures for local schools (millions)		Expenditures for local schools per $1,000 of State personal income	
		State	Local	Amounts	Ranking of State
Hawaii	0	$45	$6	$41	29
New Hampshire	$4		38	34	49
New Mexico	80	1	89	58	1

Source: U.S. Bureau of the Census, *Compendium of Government Finances* (1962), pp. 73-74, 87, 105, 107.

There are some more important public programs with benefit spillovers extending beyond the boundaries of most local governments that have not been discussed so far. Some of these activities receive well-above-average support in one or at most a few States. Table III-14 illustrates this proposition for health and hospital grants. Other activities, the most important of which are shown in table III-15, receive aid directly from the Federal Government. In one way or the other, then, most local programs with significant regional or interstate benefit flows do receive some assistance from higher governmental units, but it is difficult to judge, in the absence of a systematic study of the question, whether the differing amounts of aid provided realistically reflect interprogram variation in the spillover of benefits.

TABLE III-14.—*Five largest per capita State grants for health and hospitals in 1962*

State	*Amount*	*State*	*Amount*
Health:		Hospitals:	
New York	$2.77	Hawaii	$3.64
California	.87	Wisconsin	2.84
Kentucky	.72	Georgia	1.95
Georgia	.67	Mississippi	1.94
Pennsylvania	.65	Arkansas	1.51
U.S. average	.50	U.S. average	.52

Source: U.S. Bureau of the Census, State Payments to Local Governments, p. 12.

TABLE III-15.—*Federal grants-in-aid made directly to local governments in 1962*[1]

Programs	*Amounts (millions)*
Construction and operation of schools in federally affected areas	$256
Urban renewal	160
Low-rent public housing	149
Construction of waste treatment facilities	42
Construction of airports	33
Urban planning assistance	6
Indian education and welfare	1
Construction of health research facilities	1

Source: Advisory Commission on Intergovernmental Relations, *The Role of Equalization in Federal Grants*, p. 26.

[1] Excludes grants made to communities for demonstration purposes, research grants made to individuals employed in local public agencies, and grant program of less than $1,000,000.

The basic economic justification for Federal functional grants-in-aid is provided by the widespread, and ever-increasing, spillover of benefits from some of the most important State and local expenditure programs.[61] Under these circumstances, complete local autonomy is impossible, and effective program operation requires the development of fiscal partnerships so that all interested governmental units can participate. The appropriate means would be a set of optimizing intergovernmental grants based squarely on external benefit flows and varying with changes in the relative importance of these flows from one State and local program to another. Such grants would rationalize decisionmaking at all levels of government, improve the allocation of resources both within the public sector and between it and the private sector, and raise the general level of fiscal equity. Judged in terms of this ideal, some existing Federal grants would be discontinued because the external benefits they deal with are not national in scope, others would be consolidated into a single broad program because the external benefits of the different components are all approximately the same, and still others would be expanded so as to bring them more in line with the importance of their benefit spillovers. In addition, greater use of open-ended grants would be made so that State and local decisions to expand or contract aided programs could be based on more realistic comparisons of internal benefits and costs.

Federal functional grants may also serve as catalysts in situations where coordinated regional action is called for but where, for one reason or another, the counties, cities, and States concerned have been unable to get together. Particularly useful for this purpose are planning and demonstration loans and grants. Since the programs dealt with are not national in scope, however, primary responsibility for them should remain at the State and local level where it may be met, at least in part, by means of State grants-in-aid. One potential difficulty with this solution, of course, is that State fiscal capacities may no be equal to the task. If widespread fiscal deficiencies of this sort do exist, unconditional Federal grants-in-aid, to be discussed in the next chapter, may become an important means of strengthening the federal system.

[61] For an evaluation of Federal grants that emphasize political considerations see Phillip Monypenny, "Federal Grants-in-Aid to State Governments: a Political Analysis," *National Tax Journal*, vol. 13 (March 1960), pp. 1–16, and for a concise presentation of the economic case for Federal grants, based primarily on the existence of benefit spillovers, see Kenneth G. Ainsworth, "A Comment on Professor Monypenny's Political Analysis of Federal Grants-in-Aid," *National Tax Journal*, vol. 13 (September 1960), pp. 282–284.

Part 4

TAX CREDITS AND COORDINATION

A FISCAL PROGRAM FOR A BALANCED FEDERALISM*

BY COMMITTEE FOR ECONOMIC DEVELOPMENT

1: INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

The American Federal system relies on an active and effective partnership among all levels of government—National, State, and local. It has always been an evolving system and in recent decades the changes have been dramatic. Perhaps the most dramatic has been the assumption of costly international responsibilities by the National Government. But there have also been striking changes on the domestic scene.

1. Interdependence has grown among individuals, local communities, and the various regions of the Nation as a result of increasing industrialization and urbanization and of rapid population growth and heightened mobility. Problems that were once regarded largely as local now are of State and National concern.
2. Demands for more and better public services have accelerated since World War II, stimulated by a rapid and sustained increase in real national output and personal incomes. Still larger demands can be expected in the future as the population continues to grow and the standard of living continues to improve.
3. The National Government has developed a tax system more responsive to economic growth and more easily administered than those of State and local governments, which have traditionally had the responsibility for supplying a large proportion of domestic public services.

These changes have led to a greater role for government as a whole in domestic affairs, and to a more important role for the National Government. But the States, which have substantial powers under the Constitution, are essential to the Federal system. They stand between the local governments with their concern for community problems and the National Government with its responsibility for national defense and the "general welfare" of the country. State governments have wide legal authority to run their affairs. The States are responsible for the structure and quality of local government, and, together with their local governments, they handle most public civilian services and make the bulk of expenditures for these services.

For many years, however, States and their local units of government have not been performing as effectively as they should. State and local governments are for the most part poorly equipped to cope with the problems of the last third of the 20th century. In too many cases they are trying to serve an urban industrial society with a system developed

*Reprinted from Committee for Economic Development: *A Fiscal Program for a Balanced Federalism*, June 1967, Excerpts: pp. 8–14; 50–54; 68–70.

for an agrarian society. Since 1930 demands for improved public services have accelerated beyond the apparent capacity and will of State and local governments to provide them effectively. As a result, the tendency has been for the National Government, with its superior revenue resources, to assume more and more responsibility.[1]

The gap between State performance and responsibility could widen during the next decade as State and local governments grapple with increasing demands for better education, better housing, better transportation, and less air and water pollution. If States are to perform more effectively they must strengthen their capacity, and that of local governments, to raise the revenues needed to meet these demands. At the same time states must take steps to modernize their local governments.[2]

This Committee believes that the best interests of the people are served by a balanced federalism in which power is plural rather than centralized. It also believes that the preservation of this system depends largely on better performance by the States and their local governments. In this statement we are considering the problems of Federal-State-local fiscal relations for the period 1965–75. We will deal in a forthcoming statement with needed modernization of State government.

In the fiscal field, of course, State and local governments have not been standing still. During the 1955–65 decade their general expenditures rose at more than twice the rate of the National Government's general expenditures. They were pushed up by *population growth* of 18 percent, and an even greater increase in the age groups (school age and over-65) requiring the most costly public services; by *price increases* of 40 percent in goods and services purchased by State and local governments, compared with a general price rise of 22 percent; and by an *expansion of the scope and quality* of public services, stimulated by the postwar rise in the standard of living.

To meet these growing demands State and local governments increased general revenues from their own sources by 125 percent from 1955 to 1965. With the help of Federal aid they were able to improve the scope and quality of their public services by an estimated 24 percent per capita during that decade.

Will State and local revenue systems have enough capacity to meet future increased demands for public services that will result from the continuing influence of the three factors mentioned above? On the basis of the present State and local tax structure and the Federal aids built into present legislation, projected State and local revenues will permit an increase of 21 percent in real per capita public services provided by State and local governments in 1975 compared to 1965.

A number of fiscal steps can be taken by State and local governments to increase their revenues if voters and government officials are ready to pay for an even more rapid extension and improvement in public services than that possible with an unchanged tax structure. If additional funds are needed, State governments must improve the adminis-

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[1] See memorandum by Mr. Fred J. Borch.

[2] For a more detailed discussion of the problems, see *Modernizing Local Government*, a Statement on National Policy by the Research and Policy Committee of the Committee for Economic Development, New York, July 1966.

tration of the local property tax and increase the relative importance of State sales taxes and personal income taxes as revenue sources.

Although States must play the major role in the improvement of State and local revenue systems, the national government can and should support State and local efforts, thereby strengthening the federal system.

SUMMARY OF RECOMMENDATIONS

The United States is faced today with a conflict between two sets of values: those that are served by bigger and more centralized government, and those that are served by a decentralized system. Conflicting values such as these are as old as the Republic. There has always been a problem of achieving a balanced federalism appropriate to the nature of the society and the needs of the times. We believe that States and localities in the recent past have given in too easily to the trend toward centralization. They should now move in cooperation with the National Government to strengthen the pluralistic character of our federalism by becoming more effective and responsible. If this is to succeed, changes will be required in State-local and Federal-State fiscal relations.

To this end we make the following general recommendations, which will be followed in later chapters with more specific proposals and materials to support them.

1. Revenues from their own sources do not meet the full public service costs of local governments. The States should encourage greater cooperation and coordination among local governments in solving metropolitan problems. In many areas taxpaying ability is greatest in the suburbs but needs are greatest in the central cities. The States should do more to equalize resources available to individual local governments to combat social ills.

States should take greater responsibility for paying for education and welfare, either through direct expenditures or through grants-in-aid, in order to help equalize and improve the financial ability of local governments to meet their needs in these fields.

2. Administration of the property tax, which is essentially a local tax and is the source of almost 90 percent of local tax revenue, could be improved greatly by leadership and direction of State governments. To remedy inequities in property assessment and make the property tax more productive, a number of actions are necessary:

(*a*) States should accept full responsibility for assuring statewide equitable and uniform assessment of real property.

(*b*) Assessment ratios of all classes of real property, including land, should be equalized on the basis of market value.

(*c*) Limitations on local powers over property taxes and debts should be removed from State constitutions and, where desirable, should be imposed only by statute.

(*d*) Property tax exemptions for special private interest groups such as homesteaders and veterans should be abolished. If States continue to require such subsidies through property tax exemptions they should reimburse local governments for the revenue losses incurred. States and local governments should also nego-

tiate with private tax-exempt organizations to pay for direct public service rendered.

(*e*) States, the national government, and other public bodies should pay local governments a fair share of the local public service costs applicable to their properties.

3. The *general retail sales tax* is growing in importance because it yields substantial revenues even at low rates and because it is relatively easy to administer. However, the exemption in many States of a wide range of consumer services results in unnecessary tax losses.

The *personal income tax* is the last major source of relatively untapped State revenue. Seventeen States have no broad-based personal income taxes. About three-fourths of the States with the personal income tax have effective rates of less than 2 percent of personal income.

If they need more revenue, State governments should broaden the coverage of services under a general retail sales tax, make more effective us of such a broad retail sales tax, and make greater use of the personal income tax.

States should permit local governments to impose general retail sales taxes and personal income taxes only in the form of supplements to State taxes.

4. The National Government has a responisbility to help State and local governments become stronger members of the federal system. National decisions on fiscal policy have a great impact on State and local revenues and expenditures as well as on intergovernmental relations. We believe that the National Government should not only encourage and give financial aid to State and local governments to provide public services required by the national interest which they might be unable or unwilling to provide alone, but through fiscal policy should help strengthen State and local government revenue structures.

(*a*) State taxation of business occurs under different and sometimes conflicting rules and regulations which hamper interstate commercial activity. States tend to use tax formulas that will make their share of revenue from such activity as big as possible. The result frequently has been double taxation and taxation by States in which activity is minimal.

A system of uniform regulations establishing equitable and clear limits of tax jurisdiction upon interstate businesses by individual States should be enacted by Congress if it cannot be assured by a compact of the States.

(*b*) We believe that good management requires that the National Government review the entire system of categorical grants-in-aid to determine whether there is continued need for individual programs, whether present patterns and formulas are justified, whether the desired results are being attained efficiently, whether there are harmful by-products in such programs that should be eliminated, and whether the programs promote healthy State and local governments.

The National Government through the Congress and the Bureau of the Budget should appraise the grant-in-aid system and establish procedures for a regular review of individual grant-in-aid programs. The goal of the review should be to promote efficient use of public funds, to further beneficial participation by State and local govern-

ments, and increasingly to distribute funds according to the location of poor persons and the shortage of resources in poor jurisdictions.

(c) Two major plans have been advanced to deal with a potential federal budget surplus and to overcome restraints on State finance. One is a plan for the National Government to provide general assistance grants to the States. Essentially, this plan would transfer funds from the National Government to the States primarily on the basis of population with practically no restrictions as to their use. The other plan would provide Federal income tax reduction in the form of a partial tax credit—on top of the deductibility provisions in the present Federal income tax—allowing individual taxpayers to offset a portion of their payments of State income taxes against their Federal income tax liability.

The general assistance plan makes use of Federal income tax revenues and would be at the expense mainly of future Federal income tax reductions. The partial tax credit plan would reduce future Federal income tax revenues but encourage State income taxation.

On balance, we believe the partial tax credit plan is the preferable method to strengthen the fiscal resources and responsibility of State governments and to secure a more equitable and responsible Federal revenue system. Therefore:

When the budgetary situation permits a reduction in federal taxes, it should be accomplished in part by giving individual taxpayers a partial credit against their Federal personal income tax liability for their personal income tax payments to the state.[3]

MEMORANDUMS OF COMMENT, RESERVATION, OR DISSENT

*Page 9**—By Fred J. Borch:

I approved this statement, but I believe that too little attention is given to the fact that the States have worked very hard and diligently on the problems they have faced and that many of the States should be given great credit for the efforts they have made in the light of the great many obstacles that are brought forth in the report.

Pages 14 and 49—By C. Wrede Petersmeyer, with which Charles Keller, Jr., has asked to be associated:

I believe that each State should be free to decide which type of taxation best suits its particular fiscal requirements. The proposal herein made that would give individual taxpayers a partial credit against their Federal personal income tax liability *only* for personal income tax payments to the States would discriminate against taxpayers in such States that, for their own reasons, now prefer and may continue to prefer types of revenue-producing taxes other than income taxes.

It is one thing for CED to suggest that an income tax is a desirable form of tax for States to consider, but a far different matter for CED to insist on this type of taxation by recommending that only state income taxes qualify for Federal income tax credit. I suggest that the

[3] See memoranda of comment, reservation, or dissent by Mr. C. Wrede Petersmeyer, Mr. George Russell, Mr. Robert B. Semple, Mr. Philip Sporn, and Mr. Theodore O. Yntema, following.

*Page numbers indicated in this section refer to main volume *A Fiscal Program for a Balanced Federalism*.

credit be applied to any State-imposed taxes, whether they be income, sales or property.

Page 14—By George Russell, with which Thomas Roy Jones and Howard C. Petersen have asked to be associated:

The recommendation that the benefits of a Federal income tax reduction be tied to a State income tax credit is unnecessarily restrictive. Seventeen States, according to this statement, do not have broad based personal income taxes. The tax approach now being recommended, with which I do not agree, would tend to coerce all States into imposing an income tax (in lieu of other taxes) in order to qualify their residents for Federal income tax credits.

If Federal budgetary considerations support a reduction in Federal income taxes, this action should be given a high priority. Such an action would enlarge the tax base for all State and local governments using tax measures most appropriate to their needs.

Page 14—By Robert B. Semple:

While I concur with most of the recommendations and approve of this statement in general, I must dissent from the provision which advocates giving tax payers a partial credit against their Federal Income Tax liability for personal income tax payments to the States. I am not persuaded by the arguments in chapter 5 that either of the plans for sharing the projected Federal Income "bounty" with the States are equitable or desirable. The partial credit plan and the arguments used to support it would seem to reflect undue Federal influence on the States' tax prerogatives. A tax credit would create a gross inequity between tax payers in those States with an income tax and those in States which do not choose to enact one.

The individual State tax structures now in existence have come about through a long and delicate process involving repeated adjustments through the legislative process to arrive at a semblance of balance, recognizing the economic characteristics of each State. I am not convinced that the States cannot solve their own tax problems and reject the idea that the Federal Government must take on even added responsibility at the State level, even though it may be through an income tax incentive plan rather than direct subsidy. I feel that the present deductibility provisions in the present Federal Income Tax law are good and sufficient reasons for the States that find a need for additional revenue through the State Income Tax route to pass the necessary legislation.

An additional credit of 25 percent would be an impractical if not unacceptable proposal and I would advocate the most acceptable incentive would be reduction in the Federal Income Tax to the greatest extent possible at the earliest opportunity.

Page 14—By Philip Sporn, with which J. Wilson Newman has asked to be associated.

While I strongly endorse the need for strengthening State fiscal responsibility, I question the desirability of giving individual taxpayers a partial credit against their personal Federal income tax liability for income tax payments to the States for the following four reasons:

1. I do not believe it will solve the problem of providing funds to those States and for those purposes that have the greatest need.

2. It seems to me that such a program would lead to undermining the Federal income tax as a major element in financing the socio-economic requirements of a modern society. Rather than the beginning of a process of erosion of the Federal income tax. we need a further simplification of the tax and a tightening of existing areas of tax deductions.

3. Such a credit would reduce the countercyclical potentialities of the Federal income tax, since to the extent that such a credit is provided, countercyclical changes in tax rates would be reduced by the extent to which such credits are provided.

4. I believe that a straightforward reduction in Federal income taxes to eliminate fiscal drag on the economy would itself reduce public resistance to and thus make possible extending State and local taxes to bring about increased fiscal responsibility on the part of the States, and it would do this in a much simpler and more straight forward manner without danger of eroding or complicating the Federal income tax and reducing its flexibility.

Page 14—By Theodore O. Yntema, with which Joseph L. Block and Charles Keller Jr. have asked to be associated:

I concur in most of the general observations in this paper, but I disagree with its major policy recommendation.

This statement recommends action by the Federal Government intended to coerce the States into adopting income taxation. I am not opposed to State income taxes, but I am opposed to such Federal coercion. This statement does not establish the need or justification for such coercion. States can now levy income taxes just as well as other taxes. Since all such State taxes are deductible from income taxed at the Federal level, there is no need to go further and establish a tax credit available only to persons paying State income taxes. Unless decisions on State taxes are to be taken over by the Federal Government, the decisions on income taxes should not be forced on the individual States.

Page 24—By Robert R. Nathan:

It should be noted that included in this total of $126 billion is the $26 billion of Federal grants-in-aid. This also should be taken into consideration explicitly in later discussing the resources available for improving the scope and quality of State and local government services. Without this being noted explicitly there may be some complacency about the adequacy of internal State and local financing.

Page 32—By Charles Keller, Jr.:

Market value should of course be related, amongst other things, to income producing capabilities. Slum properties being old and dilapidated, generally receive low assessments, which in effect subsidizes them and makes them more attractive from an investment return basis. This is a situation which should be promptly reversed.

Page 34—By Charles Keller, Jr.:

While I agree with the statement, it does not go far enough. Property tax exemption for new industrial facilities, now available in many States, should also be abolished. Even where States reimburse local governments for the taxes lost through all of the listed exemptions,

other evils and imbalances are created thereby, and in some instances not all units of local government such as special districts are included in such reimbursement.

Page 34—By Charles Keller, Jr.:

The matter of the assessment of personal and intangible property is not discussed. The assessment of these classes of property is also inequitable, and their taxing, including stocks of goods in inventory, and machinery and equipment should be abolished.

Page 35—By Robert R. Nathan:

Some prevailing exemptions from sales taxes may be producing inequities, but broadening the coverage will increase inequities far more than any conceivable elimination of present inequities. To the extent that highly essential items important in low-income family expenditures are taken from exempt categories and subjected to a general sales tax, the adverse impact on poverty and on equity issues can be serious.

Page 49—By Robert R. Nathan:

The tax credit device for State income taxes, in principle, warrants full support. But it is uncertain how effective it will be in stimulating States to rely more heavily on graduated income taxes if the credit is as small as the examples presented in this report. The $700 million figure cited in appendix V is not likely to encourage much action among the States toward raising more revenues through income taxes. For this reason I would favor both the general assistance grants and the tax credit until such time as the States develop more responsive and equitable fiscal systems which are adequate to their needs, at which time general assistance grants may be reduced or eliminated.

I strongly favor a credit against Federal income taxes for State income taxes limited to a given dollar level of tax credit or as a given percentage of the Federal personal income tax liability. Such a method assures that the Federal Government will retain control over the size of the loss in Federal revenue that can or will result from the tax credit. The methods offered in appendix V will require the Congress to give a degree of open-ended access to Federal revenues. The drop in Federal revenues would be based on State legislation. Further, my method will greatly strengthen the inducement to States to adopt at least that level of taxation on incomes which will be allowed as a credit against Federal income taxes. States can set higher levels as they see fit. If we really believe that the States need more responsive tax systems or else the Federal Government will have to assume more and more financial and perhaps operating responsibilities for functions that have traditionally been handled by States and localities, then the proposed tax credit device should be one that will yield positive results.

APPENDIX V[1]—THE PERSONAL INCOME TAX CREDIT

A personal income tax credit can be provided in different ways. The simplest is to provide a credit of a flat percentage, say 25 percent, of State income tax payments in addition to permitting the taxpayers

[1] This appendix is the product of the Research Staff of CED and does not necessarily represent the views of the Research and Policy Committee.

to itemize State income tax payments as a personal deduction. Under this method persons whose State income taxes amount to $100, for example, would reduce their Federal tax by $25.

The flat percentage method favors high income persons over those with low incomes when account is taken of the deduction of State income taxes from Federal taxable income. For example, an itemized deduction of $100 for State income tax payments reduces the U.S. tax of a person in the 70-percent tax rate bracket by $70 and of a person in the 25-percent tax rate bracket by $25. The net cost of $100 of State income taxes is $30 to the high bracket taxpayer and $75 to the low bracket taxpayer.[2] Since a flat credit of 25 percent would reduce the Federal tax of both persons by $25, it would reduce the net cost of State income taxes to the high bracket person by five-sixths (from $30 to $5) and to the low bracket person by only one-third (from $75 to $50).

A more equitable method, although less simple, of providing the credit would permit all taxpayers to credit an equal percentage of the net cost of their State personal income taxes. By this method, with a 25-percent credit, the high bracket person in the above example whose net cost is $30 would receive a credit of $7.50 (25 percent × $30). The low bracket person whose net cost is $75 would receive a credit of $18.75 (25 percent × $75).

The credit, with a constant percentage of the net cost of State personal income taxes, would go to all taxpayers of State income taxes. A 25 percent credit of this type would provide a real incentive to State tax policymakers to use the State personal income tax effectively, yet limit the loss to the U.S. Treasury.

A 25-percent credit of the type suggested above would have decreased U.S. income tax revenue in 1965 by about $700 million, with the State tax structures then existing. But such a credit would result in increased use of State personal income taxes. If we assume that the introduction of such an income credit would have caused all States to tax personal incomes as heavily as Oregon, which made the greatest relative personal income tax effort in 1965, the reduction in Federal income tax receipts due to the tax credit would have been about $2.5 billion at the 1965 taxable income level.

Two examples of how the suggested income tax credit would apply to taxpayers at two different levels of taxable income are shown below:

	Case A	Case B
U.S. taxable income (after deductions and exemptions)	$15,000	$250,000.
U.S. marginal tax rate bracket[1]	25 percent	70 percent.
State income tax payments	$200	$10,000.
1. U.S. marginal tax rate bracket[1] times State income taxes	25 percent×$200=$50	70 percent×$10,000 =$7,000.
2. Net cost (State income taxes minus line 1)	$200−$50=$150	$10,000−$7,000=$3,000.
3. Tax credit equals 25 percent of net cost (25 percent×line 2)	25 percent×$150=$37.50	25 percent×$3,000=$750.

[1] 1965 rates for married taxpayers filing joint returns.

[2] The net cost is calculated by subtracting an amount equal to the reduction of Federal taxes resulting from itemization (or the amount implicit in the taking of the standard deduction) from total State income tax payments.

A third method has been proposed by the Advisory Commission on Intergovernmental Relations. It has recommended a credit which would permit taxpayers "a choice between continuing to itemize their State income tax payments or to claim instead a specified percentage of such payments as a credit against their Federal tax liability. The standard deduction provision would not be modified." The Advisory Commission uses the example of a credit of 40 percent.

The Advisory Commission method would not reduce the Federal tax costs for persons in the highest marginal tax brackets because they would be better off by continuing to itemize their State income taxes as at present than by taking the option of the credit. The credit would have some value for persons in the maximum income tax brackets below the credit proportion, who would take the option of the credit rather than itemize, and substantial value to persons who take the standard deduction since they would be permitted to continue taking this deduction and additionally to receive the full value of the credit. Because of the differences in the value of the credit, depending on tax brackets and whether the taxpayer chooses to itemize or take the standard deduction, it would be difficult for the State to attempt to take advantage of the credit by raising their own income tax rates in a manner which would be equitable to the different income groups and between itemizers and standard deduction takers.

STRENGTHENING TAXATION AT THE LOCAL LEVEL*

BY ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

The financial capabilities of governmental units are limited, in the first instance, by the taxable resources within their borders. Because local governments derive their powers from their respective States, they can draw upon revenue and other financing resources only in ways and within bounds prescribed by their State constitutions and statutes. Because local governments function in close proximity to one another in an interdependent society and economy, the effectiveness with which they employ financing resources is enhanced through intercommunity cooperation and impaired by a lack of it. The extent to which local governments pursue harmonious tax policies and otherwise act in concert is itself shaped and guided by State policies. By the same token, local government effectiveness is to an important degree influenced by the support given it by the State's stronger and more developed administrative facilities.

The most important single factor in the ability of local governments to finance their activities is the property tax because it provides, on the average, seven-eighths of all locally raised tax revenues. For this reason, this Commission has urged each State to take a hard and critical look at its property tax system. In its report on *The Role of the States in Strengthening the Property Tax*, the Commission set forth a number of guidelines to assist the States in proceeding expeditiously with property tax reform.[1] In its report on *State Constitutional and Statutory Restrictions on Local Taxing Powers*, this Commission pointed up the incongruity of property-tax-rate limitations in modern fiscal administration and recommended that they be removed from constitutions and statutes.

Local governments in every State yearn for more fiscal independence, particularly for additional local tax sources. Some would relieve the pressure on currently employed taxes; others would supplement them. The revenue requirements of local governments are increasing unevenly, even within individual States. Generally the increases are more marked in the rapidly growing urban centers, where larger numbers, possibly higher unit costs, and insistence on better government programs, generated by enlarged personal aspirations, are raising governmental requirements faster than in the less populous sections.

The quest for more local tax sources to enable individual jurisdictions to finance programs locally has diverse motivations. It postpones the need to provide financing for statewide programs and thus accords with the natural reluctance of political leadership to recognize the emergence of costly statewide problems and with their preference to

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*Reprinted from Advisory Commission on Intergovernmental Relations: *Tax Overlapping in the United States*, July 1964, Washington, Chapter 17.

[1] Described herein, ch. 6, above.

leave solutions to local governments. It harmonizes also with a deeply rooted inclination to keep government decisionmaking close to the people, which expresses itself in appeals for home rule and local self-determination. What possible objection can the legislature have, so the argument runs, to permitting a city to tax itself? In many instances, legislation authorizing special local taxes receives strong support from (and at times is initiated by) organizations of citizens interested in more adequate financing of particular functions, principally public schools.

How the States have responded to these pressures by authorizing local nonproperty taxes, was detailed in chapter 4. Where it is relevant, the individual tax chapters discuss briefly the methods by which particular States authorize local nonproperty taxes and the limitations they place upon them. Additional details are provided in another Commission report.[2]

Most States that have enabled their local governments to impose nonproperty taxes have restricted the authority to particular local governments and with respect to particular taxes. Pennsylvania is the conspicuous exception. It has authorized practically all local governments, except counties, to impose a wide variety of taxes. In consequence, several thousand income, admissions, per capita, and real property transfer taxes are now being collected by Pennsylvania cities, boroughs, townships, and school districts. In a number of instances cities and school districts have established joint collection systems. New York authorizes almost as wide a variety of nonproperty taxes as Pennsylvania but is more restrictive as to which local governments may use them. It assigns prior rights to the counties for certain taxes and to cities for others. It allows joint county-city administration of any of the taxes authorized and provides for State technical assistance to localities.

In the above-mentioned report on local tax restrictions the Advisory Commission enunciates the following basic principle, which the States should heed in granting nonproperty taxing powers to their local governments:[3]

> Most local government are smaller than the economic area in which they participate and therefore are handicapped in individually making use of income, sales, excise, and similar nonproperty taxes. Accordingly, local governments should be enabled to use these taxes only where required in the interest of the desired distribution of the combined State-local tax burden among the several bases of taxation (property, income, consumption, and business activity), and more specifically, only where increasing demands for local services cannot be reasonably met from available property tax sources or where property already bears an inordinate share of the local tax burden. Where these conditions necessitate the use of nonproperty taxes by local governments, it is incumbent upon the State to help those local governments to overcome the handicaps which necessarily attach to independently administered nonproperty taxes.

This statement reflects the Commission's evaluation of some of the handicaps attaching to the use of consumer, income, and excise taxes

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[2] Advisory Commission on Intergovernmental Relations, *State Constitutional and Statutory Restrictions on Local Taxing Powers,* October 1962.

[3] *Ibid.,* pp. 12–13.

by local governments. County, city, town, and school district nonproperty taxes generally affect business relationships within the entire economic area. Consumer taxes, whether broadly based sales taxes or levies on selected commodities or services, are likely to affect business competition between the taxing jurisdiction and the communities which surround it. Taxes on wages and salaries affect competitive relationships between the employment centers within and those without the taxing jurisdiction. Even within the employment city they raise problems, involving equities between workers residing within and those outside of that city.

The influence of tax considerations on the location decisions of business are frequently exaggerated, to be sure, particularly when the rate of the tax low and is associated with substantial differences in the quality of local government services directly and indirectly beneficial to business. In a very real sense, however, the distorting effects of taxes on business decisions are no less damaging when based on misinformation or inadequate information than when they are founded on fact.

Most consumer and income taxes imposed at rates practicable for use at the local level entail relatively high administrative costs. More correctly, they would involve high costs if administration consistent with good enforcement were provided, except where responsibility for enforcement can be shifted to others, as for instance to employers required to withhold wage taxes or public utility enterprises required to collect taxes from their consumers. Low-rate retail sales taxes pose difficult enforcement problems except where the superior collection facilities of the State administration are available.

The uncoordinated use of consumer and income taxes typically results in excessive compliance burdens for taxpayers and business enterprises, as for example where employers are required to withhold one or more local wage taxes on top of the Federal and State taxes from the compensation of individual employees.

Finally, State governments are themselves disadvantaged by the heterogeneity of local tax measures because it tends to restrict their own tax freedom and may conflict with their economic development programs. The prevalence of local income taxes in Pennsylvania was said to have swung the balance in favor of the State sales tax rather than an income tax, while the reliance of New York City on a 4-percent general sales tax and of other local jurisdictions on 2 and 3 percent taxes may effectively bar New York State from this potentially very productive revenue source. Where general sales taxes, income taxes, or selective excises are imposed by a significant number of local jurisdictions, the State has this additional hurdle to surmount in its own decision to tap the particular or a closely related tax area.

These adverse features of local nonproperty taxes can in some measure be mitigated through State action. Local governments are creatures of the State. In an historical sense, they are an administrative arm of the State and as such can be coordinated and integrated by the State to a degree alien to State-Federal relations. States can attain by direction objectives which the Federal Government can approach only by indirection.

The following are some of these possibilities at the interlocal level and statewide.

Interlocal Coordination

The shadow of intercommunity competition can effectively restrain a jurisdiction within a larger economic area from using nonproperty taxes. Just as frequently the use of these taxes actually distorts normal economic patterns within the area. To avoid such results, two or more jursidictions within the economic area may want to use a particular tax, may in fact be prepared to move in harmony by adopting a substantially identical tax measure, but are precluded from doing so for lack of authority to act in concert or because of disparities in their respective taxing powers under the State constitution or enabling legislation. Contiguous cities, counties, and towns frequently have disparate taxing powers. To meet just this kind of situation the Virginia Legislature was unsuccessfully urged some years ago to grant the two counties in the northern part of the State sales tax powers comparable to those of the two adjoining cities, in order that the four tax jurisdictions comprising the Virginia segment of the National Capital area might impose these taxes simultaneously and under identical terms. A similar request (relating to a consumers' utility tax) was turned down by the legislature in its most recent session (1964).

The adverse impact of locally imposed consumer, income, or excise taxes on economic activity and competitive relationships could in some measure be relieved if the jurisdictions comprising the economically integrated area were granted parallel taxing powers. Many of the standard metropolitan statistical areas could benefit from such legislation, although economically more meaningful groupings of local jurisdictions probably could be developed to meet individual State conditions.

Some States already have authorized groups of adjoining jurisdictions to undertake jointly functional activities they are authorized to engage in singly. New York required a constitutional amendment to empower its legislature to authorize municipalities, school districts, and other districts to provide and *finance* jointly any service which each can provide separately. This Commission's recommendation in its report on *Governmental Structure, Organization, and Planning in Metropolitan Areas* that States enact legislation authorizing two or more units of local government to exercise jointly or cooperatively any power possessed by one or more of the units concerned and to contract with one another for rendering of governmental service embraces the revenue-raising activities of local jurisdictions.

Property tax administration provides numerous examples of interlocal cooperation. Collection is exclusively a county function in 20 States, where the county collector bills the property taxes for all jurisdictions in the county. The county is also the primary assessing jurisdiction in most States. Under these circumstances, municipalities, school districts, and special districts use the county assessment roll against which to apply their property tax rates.

In the nonproperty tax area, however, interlocal cooperation is the exception rather than the rule. The authorization in New York of joint county-city administration to local nonproperty taxes has been mentioned. A 1961 enactment in Colorado authorizing a group of counties in the Denver area to band together into a capital improvement

district and to levy an areawide sales tax was invalidated by the State supreme court.

Authority to enable adjoining local jurisdictions to move in unison on nonproperty taxes would relieve intercommunity competition but might not relieve the high cost of administration and the heavy compliance burden of local taxes. Quite possibly these are insurmountable hurdles because income and sales taxes are not economical to administer at the low rates used by local governments. The problems can in some measure be mitigated, however. As a minimum, where several political subdivisions have authority to employ any of these taxes, the State could prescribe, by generally applicable legislation, standard definitions of taxpayers, tax bases, exemptions, penalties, credits, jurisdictional rules, and administrative powers to minimize uncertainty and confusion and to prevent intrastate inconsistency. Where it is appropriate, the State could prescribe procedural rules (referendum, etc.) for implementing cooperative taxation policies as well as allocation rules for the sharing of collections among the cooperating jurisdictions.

In States where payroll taxes on wages and salaries are typically imposed by two or more overlapping jurisdictions both the compliance burden on employers and administrative costs could be reduced also by pooled administration. One of the jurisdictions, preferably the larger one, could administer the tax for all of them. This arrangement appears to have been developed in some Pennsylvania areas through local initiative. Because of its scope, the problem calls for State initiative.

Statewide Coordination

The proposition that the State should actively assist its subdivisions in improving the effectiveness of the tax sources it makes available to them requires no demonstration. The parental relationship of the State to its subdivisions is adequate justification. If more were needed, it could readily be found in the case for mitigating the adverse effect of the uncoordinated local use of the nonproperty taxes on the State's economic development and efficient use of governmental resources.

If State assistance to local tax administration is viewed with skepticism at all, that skepticism is likely to stem from the local governments themselves. Their sensitivity to home rule, their attachment to local autonomy, breeds suspicion of State intervention in local tax matters. At the very least, it dampens local enthusiasm for seeking State help in tax administration.

Another barrier is the absence of a common interest among some adjoining jurisdictions, stemming in part from differences in the urgency of finding additional revenue and in part from the unequal impact of most taxes on adjoining jurisdictions. The improved effectiveness of local sales taxes is likely to interest the jurisdiction which serves as the area's trading center; it is not likely to elicit support from the residential suburbs. Similar conflicts of interest are likely to prevail between employment centers and residential suburbs with respect to local income or earnings taxes. The association of a tax with a service potentially beneficial to the total area may promote some areawide solidarity in tax policy but entails the weakness of taxes earmarked for

specific uses. An alternative, as noted above, is the prescription of revenue allocation rules by the legislature.

Technical assistance.—The State can assist local tax areas in various ways short of taking a direct hand in tax collections. It can serve as a clearinghouse of information on the experiences of other jurisdictions. It can provide training facilities for local personnel. It can provide technical advice on tax administration. It can afford local jurisdictions access to relevant State tax and related records. In some situations it can use sanctions on behalf of local jurisdictions. Local administration of personal property taxes on automobiles would be measurably eased, for example, if evidence of their payment were made a prerequisite to State registration of motor vehicles. Where local registration fees are imposed, evidence that the local tags had been purchased before State tags are issued would be equally effective.

There are many opportunities for State technical assistance in the property tax field. More than half of the States are now conducting periodic assessment-ratio studies, which provide information on the uniformity of local assessments. Most States cooperate in the conduct of annual schools for assessors. Many States provide uniform assessment records and help prepare tax maps and other tools essential to effective property valuation.

Tax administration.—A special situation prevails where local use of a particular nonproperty tax is statewide, or nearly so, and where reasonably uniform tax bases and rates are, or can be, employed. The conspicuous example is Pennsylvania, where more than 1,800 cities, boroughs, townships, and school districts impose income taxes, frequently overlapping. Ohio with more than 80 city income taxes is another example. In these situations a statewide administration warrants consideration. In neither Pennsylvania nor Ohio is income subject to State taxation, and the question has been raised whether the constitutional provisions which have been invoked against the enactment of State income taxes would not also bar State administration of local income taxes. This is not the place to consider the constitutional question if one exists. In any event, nothing in its constitution should preclude a State from assisting its political subdivisions in organizing a joint tax administration for themselves.

The local income tax situation in Pennsylvania and Ohio is unique. More generally the local taxes overlap State taxes and provide ready scope for cooperation in tax administration. Property tax assessment administration is a particularly fertile field for active State leadership and direction. Only one State, Hawaii, administers the local property tax at the State level, but assessment of utility property is a State function in many States. Maryland comes close to having a State-administered property assessment system through county supervisors of assessments who are responsible to the State Department of Taxation and Assessments.

Tax supplement.—A special and highly developed application of cooperation in tax administration is the tax supplement device. Where a particular tax (base) is used for both State and local purposes, a logical administrative device is the tax supplement. The local rate is added to the State rate, both are collected by the State administration, and the allocated share of the collections(on the basis of geographic

origin) is credited to the account of the local taxing jurisdiction. The classic American example is the manner in which some States still share the property tax with their political subdivisions. Administration in these cases is generally local, occasionally State. In Alabama, municipalities can provide by ordinance (and most of the large cities have provided) for the assessment and collection of personal property taxes through the State machinery.

In Nevada the State collects a 1-cent gasoline tax for the counties, which they have the privilege (by resolution) not to impose. None has taken advantage of the privilege.

The tax supplement has important advantages. It involves the use of identical State tax definitions (taxpayer, tax base, tax calendar, etc.) by all local jurisdictions. While some State definitions may leave scope for improvement, the advantages of uniformity for ease of compliance are self-evident. The local supplement is collected together with the State tax, eliminating the need for duplicate administration, with corresponding alleviation of compliance burdens. Where the local jurisdiction is charged a fee for the collection of its tax, these funds supplement the State's own typically inadequate appropriations for tax enforcement.

The tax supplement, moreover, leaves the responsibility for imposing the tax and fixing its rate (generally within limits prescribed by the State) with the local jurisdictions. It enables the electorate in each jurdisdiction to balance the case for the tax against the need for the additional local services and thus leaves scope for intrastate differences in the level of government services (necessarily at the cost of intrastate tax-rate differentials). However, the degree of local autonomy exercised in these situations may be ephemeral only. Experience suggests that frequently when local governing bodies are granted authority (without referendum requirement) to add local tax supplements, the tendency is to utilize the authority. This appears to be the burden of the experience with local sales-tax supplements in California and Illinois. And even in Mississippi, where a 1-percent local rate can be imposed only with electoral approval (a rate of one-half of 1 percent can be voted by the governing body but citizens have the right to initiate a referendum), 151 municipalities now levy local sales taxes, and the voters in three-fourths of them have approved the higher rate. Examples can be cited, however, to demonstrate the contrary, particularly if the authority is subject to electoral approval.

Since the proceeds of local supplements accrue by definition to the imposing jurisdiction (the revenues are left in the jurisdictions where they are collected), problems of allocation among jurisdictions present in grants-in-aid and shared revenues are avoided. By the same token, however, variations in need relative to local resources are disregarded.

Recent experience with tax supplements has been particularly successful in sales taxation. The device was first used by Mississippi in 1950 and has spread to five other States. Since 1955 it has been in use in California, where both county and city taxes prevail. In that State the legislative limit on both the county and city rate is 1 percent, but the city tax is allowed as a credit against the county tax. Thus the net county rate within a city may vary from 1 percent, where the city eschews the tax altogether, to zero if the city levies the 1-percent rate.

Today the 1 percent local supplement to the 3-percent California State tax is statewide, all cities and counties levying it.

In Illinois the privilege of adding a local suppement to the State's sales tax was utilized (as of January 1, 1964) by approximately 1,170 out of 1,251 municipalities and by 68 out of 102 counties. The sales-tax supplement is used also in New Mexico, Tennessee, and Utah.

In Alabama, where 18 counties and 77 municipalities impose sales taxes, a number of the county and city taxes are administered by the State Department of Revenue. Colorado in 1963 authorized cities imposing local sales taxes to contract with the State to collect their sales taxes for them.

While tax supplements have received their greatest public notice in connection with sales taxes, the technique has potential in other areas where local taxes duplicate State taxes. Moreover, local use of the tax need not be statewide. The supplement would appear to have considerable scope with respect to motor vehicle registration fees where local licensing of vehicles is a widespread practice. It has been discussed also in connection with local income taxes. It presents some problem here because States tax the total income of their residents from whatever geographic source derived, while local income taxes generally apply to earnings from employment within the taxing jurisdiction.

Tax credit.—The tax credit is a device by which a taxing jurisdiction invites a subordinate jurisdiction to share with it a prescribed portion of a tax area. It is used also to enable two coordinate jurisdictions to share a portion of the tax.

The purpose of the credit is accomplished by permitting the taxpayer to discharge a specified portion of his tax liability to one (the superior) jurisdiction with receipts for an identical kind of tax paid to other (subordinate) jurisdictions. The credit, it will be noted, is to the taxpayer, and not to the taxing jurisdiction. Since the taxpayer's liability is the same whether the subordinate jurisdiction uses the tax (which gives rise to a credit) or not, the availability of the credit exerts a strong compulsion on the subordinate jurisdiction to impose the tax up to the limit of the credit. Why forego the tax when it adds nothing to the tax burden of the local citizen—when it merely diverts to the local treasury revenues which otherwise would go to the State?

While the tax credit was used as early as 1918 to minimize international double taxation of Federal income taxpayers, its use in tax coordination among the constituent governments of the United States dates from 1924, when it was first employed to give States a share of the Federal estate tax (ch. 10). In 1936 it was also employed to encourage the States to establish unemployment compensation programs.

The tax credit has had only limited application in inter-local and State-local relations. Two States (California and Utah) are using it to limit the aggregate of city and county sales taxes by requiring the county to allow credit for the sales tax paid to cities. The city of Louisville and Jefferson County, Ky., provide an example in the local income tax field. Both the city and the county impose an income tax ("occupational license") at the same rate. Jefferson County allows taxpayers subject to the Louisville tax a credit for that tax. An example of the use of the tax credit in State-local tax relations is the Florida cigarette tax credit. In 1949 Florida authorized muncipalities to levy

cigarette taxes at a rate not exceeding the State rate of 5 cents a package (increased to 8 cents by the 1963 legislature), with a corresponding tax credit against the State tax. All jurisdictions promptly imposed 5-cent cigarette taxes (now 8 cents). In Florida the State collects the tax, withholds 4 percent of collections to cover administration costs, and returns the balance to municipalities in proportion to collections. Proceeds of the tax in areas outside municipalities are reserved for the State. Other incidental uses of the credit occur here and there. Virginia, for example, allows municipal taxes on shares in incorporated banks to be credited against the corresponding State tax.

In view of its coercive aspects, the tax credit is closely akin to a State-imposed tax shared with subordinate jurisdictions on the basis of collections. In its Florida application, the tax credit in effect produces a State-collected, locally shared cigarette tax.

In its more familiar application, as in the Federal estate and unemployment insurance taxes, the credit is consistent with, and in fact contemplates, State tax rates in excess of the tax credit. In a State-local context, a case could be made for limiting local rates to the amount of the credit in order to avoid intercommunity tax rate differentials.

While the local and State taxes based on a tax credit are separately administered, the benefits of superior State administration spill over to local jurisdictions so long as the State retains a significant enough share of the tax to leave it with an incentive to make an enforcement effort. This would not be the case where the credit absorbs substantially all of the nominal State tax liability.

Perhaps the strongest feature of the tax credit is its tendency to equalize tax rates among jurisdictions, thereby curtailing intercommunity tax competition. While tax rate differentials are precluded only if the local tax rates cannot exceed the credit, some equalizing tendency prevails even in the absence of local rate ceilings. The tax credit enables each jurisdiction to impose a tax rate up to the amount of the credit without affecting the combined State-local tax liability. This serves as a floor below which competitive tax rate cutting is eliminated because the tax credit makes it pointless.

Tax sharing.—The most familiar intergovernmental device in State-local tax relations is the shared tax. The tax is imposed by the State and its yield shared with local governments. Typically the tax is State administered. On occasions, however, as in the case of some State death duties and automotive license fees, it is locally administered with a portion of collections retained by the administering jurisdicton.

The advantages of a State imposed and locally shared tax over separately imposed State and local taxes are several. Dual tax administration is eliminated. Local governments are afforded the benefit of the State's superior enforcement facilities. It eliminates scope for intercommunity tax rate competition and results in a statewide tax rate level deemed consistent with State policy. These benefits are obtained without impairing local independence with respect to expenditures.

Local sharing of State taxes, however, is not without its shortcomings. Local fiscal independence is impaired to the extent that decisions as to the kinds of taxes used, tax rates, etc., are removed from local determination. Conceivably some jurisdictions have no need for the revenue or would prefer to do without the tax burden and the revenue.

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The basis of sharing, moreover, poses difficulties akin to those present in grants-in-aid and exposes local jurisdictions to the fortunes of the political power balance in State councils. Tax sharing does have a practical advantage over grants-in-aid in that it escapes the periodic budget debate over how much should be appropriated for it.

A common basis for tax sharing is collections within each jurisdiction. This is readily workable with respect to such revenues as motor vehicle registration fees or taxes on utility services. Here the geographic origin of the revenue can be readily identified. The task is more difficult, however, in the case of general sales taxes since the distribution of revenues on the basis of collections will overstate the contribution of the marketing areas. It is most difficult in the case of income taxes because a resident normally files his tax return in the jurisdiction where he resides and a business organization where its headquarters are located while the income of both may and probably does represent activity scattered over a large area.

Because of these kinds of considerations, distribution of revenues on bases other than collections is not uncommon. Sometimes population or school enrollment is used. In the case of automotive taxes, the distribution formulas may be related to highway needs. Objective standards for distribution, however, are illusive. Where the bases of distribution are collections or population within each jurisdiction, the effect may be at marked variance with relative need, with excessive distributions to some jurisdictions and inadequate shares to others.

Finally, since distributions are on the basis of collections, the yield of shared taxes fluctuates from year to year and shifts the burden of adjusting expenditure levels from the State, which typically is better able to absorb it, to local jurisdictions. This consideration, however, has more relevance in comparing shared taxes with grants-in-aid than with other State-local tax arrangements.

Tax sharing may well serve as a substitute for locally imposed taxes where they are widespread within the State, especially if the local tax rates tend to be uniform. In 1961 Maryland increased its State cigarette tax by 3 cents, the approximate rate of the prevailing county cigarette taxes, and earmarked the added revenue for counties, on the basis of population. At the same time, it prohibited the further imposition of local cigarette taxes. By this measure, it made the State's more efficient and economical enforcement resources available to the counties, and eliminated intrastate tax rate differentials.

Coordination Possibilities

In its report on *Local Nonproperty Taxes and the Coordinating Role of the States*, this Commission concluded that the widespread use of miscellaneous kinds of local taxes across the country poses problems of public policy and affords State governments an opportunity to foster State and National objectives by maximizing the effectiveness and minimizing the adverse results of local tax practices. Admittedly the interstate variation in division of functions, taxes, and financing arrangements and the intrastate variation among different local jurisdictions preclude the formulation of generally applicable prescriptions for State coordination

of local taxes. Local government finance in the United States is a heterogeneous institution, nationally as well as within most individual States. Our sketchy description of State-local tax arrangements involving some 80,000 separate taxing entities makes this abundantly clear. While the Commission recognized the improbability that local fiscal problems are susceptible to common solutions, it had no difficulty in identifying a number of techniques with substantive potential in at least some States and tax areas. Accordingly it set forth a number of general guidelines it believes to have potential usefulness in some situations in some States, probably none in all of the States. Specifically, the Commission suggested that—[4]

(1) The case for most nonproperty taxes is strongest in the large urban places. Even here, these taxes are best imposed cooperatively by a group of economically interdependent jurisdictions. Therefore, the city and the other jurisdictions comprising an economic area should be provided with (*a*) uniform taxing powers and (*b*) authority for cooperative tax enforcement. The States should take active leadership in promoting the pursuit of coordinated tax policies and practices by these economically interdependent jurisdictions.

(2) In States where a particular tax, such as the sales or income tax, is in widespread use by local governments and is simultaneously used also by the State, the most promising coordinating device is the local tax supplement to the State tax. It gives local jurisdiction access to the superior enforcement resources of the State and eases taxpayer compliance but leaves the decision to impose the tax to local initiative.

(3) In situations where a particular nonproperty tax is widely used locally but the State does not itself use the same tax the State can nonetheless help local jurisdictions by facilitating the pooled administration of the separate local taxes by a State administrative agency; alternatively, it can authorize local jurisdictions to join in creating such an administrative agency for themselves.

(4) States can minimize needless variety among local nonproperty taxes by accompanying the authorization for using them with generaly applicable specifications with respect to their structure (tax base, exemptions, etc.) and administrative features.

(5) Individual States' tax policy should aim to limit local government to the more productive taxes. Local jurisdictions should be discouraged from levying many different kinds of taxes, none of which produces enough to warrant reasonably good enforcement. Extensive tax diversification is not practicable at the local level, especially in the smaller jurisdictions.

(6) States should provide their local units with technical assistance by serving as a clearinghouse of information on tax experience in other parts of the State and country, by providing training facilities for local tax personnel, by giving them access to State tax records, and where it is appropriate, by employing sanctions against State taxpayers who fail to comply with local tax requirements.

[4] Advisory Commission on Intergovernmental Relations, *Local Nonproperty Taxes and the Coordinating Role of the States*, September 1961, p. 6.

(7) While the tax-sharing device may run a poor second to grants-in-aid, where the objective is to provide State financial assistance to local units on a stable basis, it has distinct advantages as a substitute for locally imposed taxes where they are widespread within the State, especially if the independently imposed local tax rates tend to be uniform.

(8) The tax credit device affords little scope for State-local tax coordination. Its chief value is in coordinating the use of the same tax by overlapping local units, as for example, county and city sales taxes, and for reconciling the competing taxing jurisdiction of two or more States, as in the case of State taxation of the income of nonresidents.

FINDINGS AND RECOMMENDATIONS*

BY ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

The times are auspicious for reexamining intergovernmental relations in personal income taxation. Changes in both Federal and State income tax policies and viewpoints are affecting interrelationships with significant implications for "the conventional wisdom" on how best to accommodate them to one another, how best to cordinate them.

FACTORS AFFECTING INTERGOVERNMENTAL RELATIONS IN PERSONAL INCOME TAXATION

THE PROBLEMS OF TAX OVERLAPPING

Some Americans have lived with overlapping Federal and State taxation of their personal incomes for half a century; nearly two-thirds of them for a quarter century. An additional number have now had years of experience with Federal-local duplication.

Since its introduction with modest tax rates and generous personal exemptions, the personal income tax has become the National Government's major tax source. It is presently producing at an annual rate of approximately $50 billion. Some States experimented with income taxes as long as a hundred years ago, but the modern State personal income tax is largely a contemporary of the Federal tax. The 33 States that now collect this tax raise over $3½ billion from it.[1] About half of them, however, do not use the tax effectively. This circumstance and the uneven distribution of personal incomes among the States explain the fact that 10 States collectively account for 80 percent of all State collections.

Over the years, overlapping income taxation has acquired the status of an accepted institution. The reconciliation to dual taxation has come more quickly in the income tax area than in some of the others. The succession of study groups, commissions, and tax experts who had labored since the turn of the century in behalf of a separation of the major tax sources, assigning each tax to one or another level of government, gradually abandoned their favorite remedy when they prescribed for income taxation. The record is inconclusive and we can only surmise their reasons for excluding the income tax from programs of revenue separation.

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* Reprinted from Advisory Commission on Intergovernmental Relations: *Federal-State Coordination of Personal Income Taxes*, October 1965, Washington, Chapter I.

[1] Since we limit our discussion to "broad-based personal income taxes now in operation, our count of 33 State taxes excludes (*a*) the New Jersey "commuters' " income tax, which applies only to New York residents working in New Jersey, (*b*) the New Hampshire and Tennessee taxes, which are limited to income from interest and dividends, and (*c*) the newly enacted Nebraska personal income tax which becomes effective on Jan. 1, 1967, and then only if approved by referendum. Some of the subsequent discussion, particularly that relating to legislative developments, necessarily includes the Nebraska tax.

One likely factor was general appreciation that the deductibility of State taxes for Federal income tax purposes affords some relief from the dual tax burden and that the degree of relief increases the higher the tax rate otherwise applicable to the taxpayer. This particularly impressed those troubled by the possibility that the addition of State to Federal tax rates might preempt substantially all income in the upper brackets.

It is relevant, too, that much of the support for the separation of State and Federal revenue sources stemmed from preoccupation with the States' problems. The States were believed to be at a tactical disadvantage, as compared with the Federal Government. Revenue separation was viewed as a device by which the National Government would relinquish tax sources to the States, *not vice versa*. The inappropriateness of this prescription for income taxation became progressively clearer as the Federal Government's revenue requirements and the degree of its reliance on income taxation increased. The States stake in the income tax, in any event, did not appear to be large. Only a few States derived significant revenue from it; most of the industrialized States did not use it at all.

Perhaps more important than any of these considerations was the spread of techniques for alleviating the double compliance burdens of taxpayers and keeping down the cost of dual tax enforcement. The tendency of States to adopt some Federal Revenue Code definitions, their ready access to Federal tax returns, their opportunity to exchange audit results with the Internal Revenue Service, and the development of tax withholding to ease the payment and collection of taxes on wages and salaries, all helped to allay concern over compliance burdens and enforcement costs. The fact that the employment of tax practitioners for preparing tax returns became general, particularly among large income recipients—those most likely to be affected by the more complex provisions of duplicating revenue laws—also may have played a part in the acceptance of tax overlapping.

While the familiar checklist of the different kinds of taxes used by the several categories of government designed to dramatize the extent of overlapping for years has had two, three, or more checkmarks opposite most taxes, the discerning have long recognized that a large degree of tax separation does in fact exist in the American system. The perceptive knew that the National Government obtained about 80 percent of its tax revenues from personal and corporate income taxes; that local governments derive over 85 percent of theirs from property taxes; that States depend for nearly two-thirds of theirs on consumption taxes; and that tax overlapping, in the aggregate, involves not more than a sixth of all tax collections.

Those concerned with the pattern of tax burden distribution were consoled by the fact that the Federal Government, which relied so largely on the graduated income tax, was the major and the growing tax collector. Similarly, those preoccupied with the relationship between tax policy and stable economic growth reckoned primarily with Federal policies, believing that budgetary constraints necessarily immobilized State and local government—that these governments, preoccupied with the need for stable revenues, lacked the income flexibility required to practice fiscal policies other than "budget balancing."

The changed role of government in American life since the Second World War, particularly in the parts played by the Federal Government on the one hand and State and local governments on the other, has had important consequences for income tax relationships, including the problem of income tax overlapping.

THE FISCAL PLIGHT OF STATE AND LOCAL GOVERNMENTS

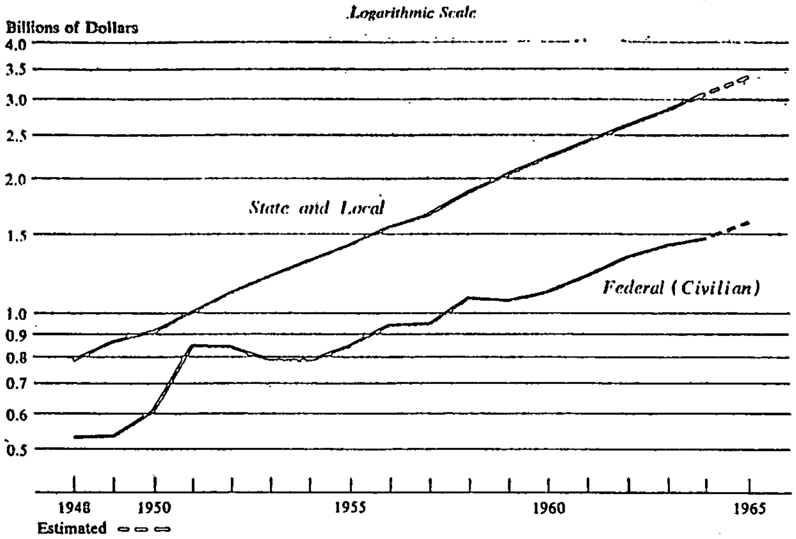
The overriding fiscal need of State governments (including their local governments) is more tax revenue, particularly a tax source with a strong revenue growth potential in a growing economy. This immediately focuses attention on the personal income tax because, in a majority of the States, it is either the least effectively used major tax source or not used at all, and because it responds to economic growth more than any other tax.

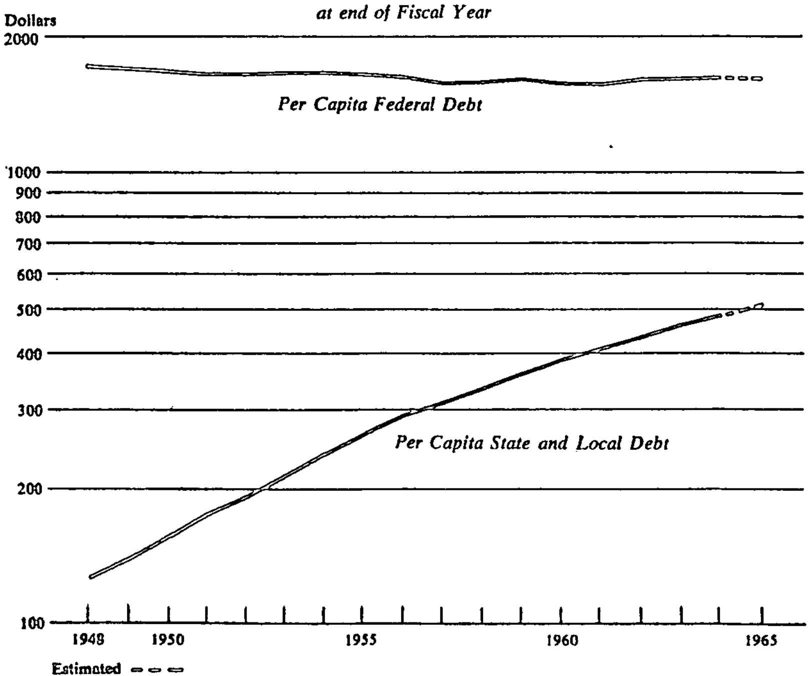
As we point out in the immediately following chapter, State and local spending has been rising at an unprecedented annual rate of 8 to 9 percent a year, strikingly faster than the Nation's output of goods and services (GNP). A 145-percent postwar increase in GNP has been accompanied by nearly a 300-percent increase in State-local general government expenditures.

The Nation's growing economic affluence generates more than a proportionately increased demand for more, better, and costlier governmental services, and the impact of this rising demand falls primarily on the States and their local governments because the provision of most governmental services is primarily their responsibility. This feature of our system of government explains the facts that between 1948 and 1964 the annual level of State and local governments' spending for general government purposes increased by $52 billion compared with a $14 billion increase in Federal general expenditures for civilian domestic purposes; that the number of their employees increased by 90 percent compared with 22 percent (Federal civilian); and that their per capita debt increased $355 while Federal per capita debt actually declined by $91.

Moreover, the recent rate of increase in State and local spending can be expected to persist at least for some years because the forces that produced it continue to be operative and additional ones are developing. The total population and the proportion of it consisting of older people and of those living in the relatively costlier urban areas will continue to rise. Also, as the people's prosperity continues to improve, their demand for improved community amenities will grow apace. The National Government's emphasis on social programs to speed the realization of "Great Society" goals will operate in the same direction.

We have in mind also the need to correct the accumulated deficiencies in public facilities and services in the many parts of the country bypassed by recent improvements. The publicized improvements in such national averages as per pupil expenditures for public education, per case expenditures for general relief, and per capita public health expenditures obscure the fact that the level of program support in some States is barely half, in some only a third, of that found in the leader States.


FEDERAL AND STATE-LOCAL MONTHLY PAYROLLS, 1948 TO 1965
Logarithmic Scale
Billions of Dollars
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.9
0.8
0.7
0.6
0.5
State and Local
Federal (Civilian)
1948
1950
1955
1960
1965
Estimated


FEDERAL AND STATE-LOCAL DEBT, 1948 TO 1965
at end of Fiscal Year
Dollars
2000
Per Capita Federal Debt
1000
900
800
700
600
500
400
300
200
100
Per Capita State and Local Debt
1948
1950
1955
1960
1965
Estimated

In contemplating the future, we must reckon also with the fact that as time goes on, the scope of services provided by State and local governments will tend to increase because programs now known only to a few pioneering communities will tend to become the accepted norm. The educational and welfare cost implications of a national undertaking to rectify the educational and employment handicaps of the underprivileged, for example, can easily add several billion dollars to the annual level of spending within the next several years.

The ability of State and local governments to meet their growing revenue needs is becoming an increasing intergovernmental concern. On the one hand, the economic, social, and international policy objectives of the Federal Government create part of the increasing demands being made on State and local governments. On the other hand, these same national objectives are jeopardized when inadequate revenues oblige these governments to leave critical needs unmet. Congressional recognition of this Federal-State-local interdependency is being demonstrated with increasing frequency by the enactment of grant programs in functional areas hitherto left to State and local initiative.

While State and local governments' revenue needs continue to rise significantly faster than the economy, the revenue yield of their tax systems, apart from the contribution of new enactments and rate increases, does well to keep pace with economic growth. This results from the kind of taxes they employ. Consumer and property taxes account for over three-fourths of all State and local tax revenues. As we point out in chapter 2, an increase in the GNP of say 10 percent raises total consumer tax receipts by less than 10 percent because, as people's incomes rise, they tend to devote a declining share to some categories of consumer expenditures. The response of the property tax to economic growth also has tended to be less than proportional although the more recent evidence suggests that, for the present at least, property tax revenues (with benefit of new construction and rising property values) keep pace and possibly somewhat outpace the economic growth rate. In contrast, the personal income tax has a very striking growth potential, as the Federal income tax has made clear for some years. As income levels rise, single persons and families with very low incomes move into taxable brackets and those in the lower brackets into the adjoining higher tax rate brackets. However, since the personal income tax, even after its recent rapid growth, provides only about 14 percent of State and only 8 percent of combined State and local tax revenues, its present influence on total State and local tax system is quite diluted.

The income tax is of timely interest also because State activity in this field—new enactments as well as rate adjustments—is on the increase. Also, States are beginning to experiment with using the income tax to blunt the burden of the two major local and State taxes (real property and retail sales) on the very low income groups.

In chapter 3, where we trace the income tax movement in the States, we point out that after the frenzied legislative activity during the depression, the income tax movement came to an abrupt halt on the eve of World War II. After 1937, nearly a quarter century went by without a single State joining the States that had an income tax by that

time.[2] More recently, State income tax activity has resumed. In 1961 West Virginia, in 1963 Indiana, and in 1965 Nebraska adopted this tax. Several other States are actively debating its adoption. Moreover, during 1965, eight States increased their personal income tax rates.

Recently, four States have embarked on using their income taxes to free the low-income groups of excessive sales and property tax burdens. Wisconsin uses the vehicle of its income tax to rebate to elderly people a portion of their property tax bill in excess of a prescribed percentage of their income. Indiana, Colorado, and Hawaii use the income tax to relieve taxpayers of sales taxes paid on specified amounts of food purchases. In each instance, the relief is provided in the form of a credit against income tax liability with cash refunds (negative tax credit) to those whose income tax liability is insufficient to exhaust the credit.

In an earlier report we described the spreading competition among States and communities for commerce and industry.[3] For some, the primary motivation is to provide employment and increased business; for others, the prospect of added tax revenue without tax rate increases. Whatever the motivation, the ability to attract new business firms and to hold on to old ones is rapidly becoming a symbol of political leadership.

The level of tax rates is—or at least is believed to be—a factor in this competition. Political leadership sensitive to this issue places a premium on spreading the taxload among as many different kinds of taxes as possible (and in the making the base of each tax as broad as possible) so that tax rate levels required to produce the necessary amount of revenue can be minimized. This line of reasoning fosters interest in the income tax in States now without this tax and in those with relatively ineffective income taxes.

State interest in income taxation is enhanced also by the improved stability of its yield. The few States that had relatively well-developed income taxes by the 1930's were hard hit by the impact of the depression on their collections, all the more damaging because States lack the statutory authority to use deficit financing for operating costs. In the ensuing emphasis on States' need for depression-proof taxes, the income tax was understandably downgraded. Increasing public confidence in the ability of national economic policy to sustain stable economic growth and to prevent the recurrence of serious economic recessions is gradually offsetting this "unstable revenue yield" association with income taxes.

At the same time, national preoccupation with social and economic policies to improve the lot of the economically underprivileged groups in the population is focusing attention on the pattern of State tax burdens and more particularly on the potential usefulness of the income tax in reshaping the distribution of State tax burdens to harmonize better with national social policy objectives.

Rising State and local consumer and property tax rates are increasing the weight of regressive and business cost taxes at a time when Federal fiscal policies are reducing the progressiveness of the Federal income tax. The increasing regressivity of the Nation's total

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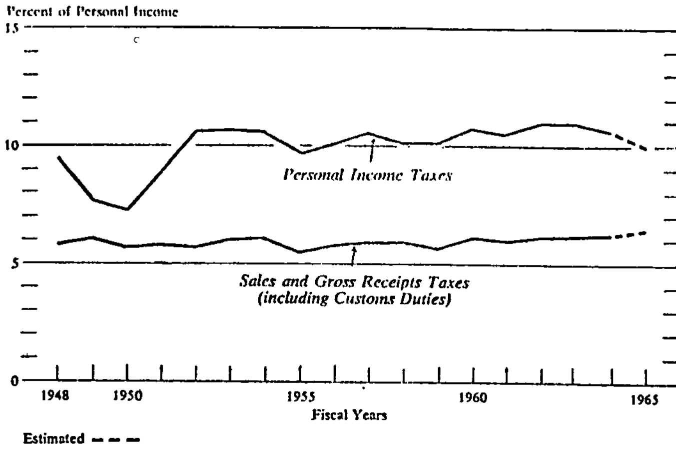
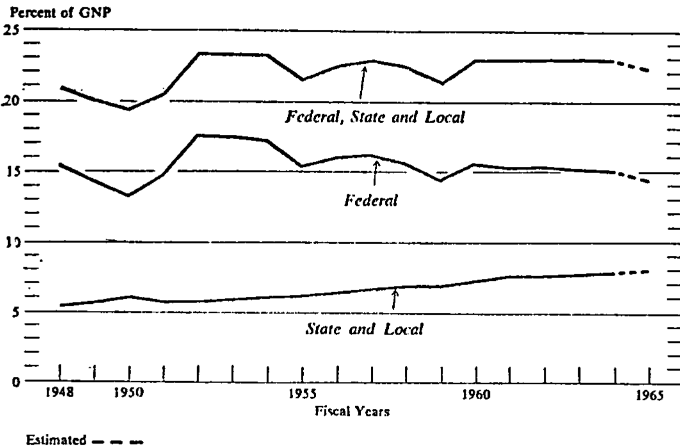
[2] Alaska adopted its tax in 1949, when it was still a territory.
[3] *Industrial Development Bond Financing* (A–18), June 1963.

PERSONAL INCOME TAXES AND CONSUMER TAXES AS PERCENTAGE OF PERSONAL INCOME, 1948 TO 1965



TAXES AS PERCENTAGE OF THE GROSS NATIONAL PRODUCT, 1948 TO 1965



tax structure undercuts the administration's efforts to wage war on poverty through direct expenditure programs and Federal tax revision.

In a very real sense, the growing weight of regressive State and local taxes tends to frustrate these governments' own revenue objectives. It is obliging them to mandate costly, inefficient, and clumsy tax exemptions, thus aggravating their revenue shortages. Exemption of food from sales taxes is the outstanding example. Exemption of the aged and veterans from property taxes, discussed in one of our earlier reports, is another.[4] The search for more economical ways to mitigate

[4] *The Role of the States in Strengthening the Property Tax* (A–17), June 1963, vol. 1, ch. 8.

the burden of consumer and property taxes on the low income groups is also contributing to the revival of State interest in personal income taxation.

THE ROLE OF THE FEDERAL GOVERNMENT

We have already noted that although both the Federal Government and the States have been active in income taxation for about 50 years, the field has been dominated by the Federal Government, particularly since World War II. The virtual halt in the State income tax movement noted above is at least partially traceable to the "preemptive" high Federal tax rates. For more than three decades, as the Federal Government pursued its objective of placing more and more relative dependence on income taxes, it was generally assumed that increasingly higher Federal tax rates was the wave of the future, diminishing the scope for State participation in this tax area.

Now, for the first time since the 1920's, the National Government is embarked on an economic policy, initiated with the 1964 income tax reductions, that holds out the prospect of successive future tax rate reductions. This is taking place against a background of increasing acceptance of the theory that by reducing the fiscal drag, tax reductions can contribute to stable economic growth so that revenue productivity can be preserved and increased despite lower tax rates. Presumably, this enlarges somewhat the potential of State income taxation, both by leaving the States more "elbow room" and by enhancing the revenue productivity of their taxes at any rate level.

Mention should be made also of the increasing public emphasis placed on the States' needs for more revenue by the leadership of the National administration in recognition of the key role of State and local governments in the attainment of national economic and social policies. Finally, a recently developed interest in proposals that the Federal Government share some of its Federal income tax revenue with the States is throwing the spotlight on the varying effectiveness with which the States are utilizing their own powers to tax personal incomes.

THE NEED FOR REEXAMINATION

It is clear, then, that both national and State developments combine to make this a propitious time to reexamine intergovernmental income tax relations, in the interest of augmenting the fiscal resources of the States, lending support to the policy objectives of the National Government, and exploring new opportunities for reducing the compliance burdens of taxpayers and improving the efficiency of tax administrations.

In short, the problem we pose for ourselves in this report is how best to adapt State income taxation and more particularly Federal-State income tax relationships to the emerging economic, fiscal, and political environment. As the foregoing discussion and more particularly the detailed discussion in subsequent chapters makes clear, our consideration of this problem is influenced by a number of objectives we deem to be of timely importance:

The need to improve the revenue producing strength of State and local tax systems;

The need to increase the revenue responsiveness (elasticity) of State and local tax systems to economic growth;

The need to minimize the level of tax rates, to offset each State's fear of competition for commerce and industry from the other States;

The need to enable the States to retain maximum control over the structure of their tax systems;

The need to minimize jurisdictional conflict between States;

The need for conforming the tax burden distribution of State and local tax systems (particularly on those with small incomes) to national social policy objectives;

The need to preserve the Federal Government's freedom of income tax action for future national crises; and

The need to minimize the compliance burdens of taxpayers, improve the operating efficiency of tax administrations, and foster tax simplification.

We turn now to an examination of the issues we believe to be controlling in the accommodation of State and Federal personal income taxes in the light of these requirements. More specifically, we address ourselves to these questions:

1. What should be the role of the personal income tax in State tax systems?
2. What part, if any, should the Federal Government play in facilitating that role?
3. What should be the relationship between the structure of State and Federal income taxes?
4. How can Federal-State administrative cooperation be enhanced?
5. How can income tax relationships among States be improved?
6. How can State-local income tax relationships be improved?

These problems are here examined in the order enumerated.

It will be noted that we deliberately exclude from our present considerations the range of issues associated with proposals that the Federal Government relinquish some of its revenues to State and local governments. These proposals have taken various forms. In recent months considerable public attention has focused on the suggestion that when it again becomes opportune for the Federal Government to reduce income taxes, it consider the alternative of diverting part of its surplus revenues to relieve the fiscal pressures on State and local governments. We do not here consider this group of proposals. It is subject enough for a separate report. It is in any event tangential to our present concern with a need to strengthen the Federal system by helping the States to help themselves out of their own resources. We have undertaken to examine the personal income tax in this context because a majority of the States are presently not using it at all or use it only ineffectively and this interstate variation contributes significantly to the wide divergence in the comparative tax efforts made by the 50 States.

Policy Issues and Recommendations

THE ROLE OF THE INCOME TAX IN STATE TAX SYSTEMS

The personal income tax presently supplies about 14 percent of the States' and about 8 percent of State and local governments' aggregate tax revenues. Its relative role in individual States varies widely not only because of differences in the level of personal incomes but also because of different degrees of taxation.

One-third of the States do not tax personal incomes at all and another third tax them at relatively low effective rates. In contrast, the National Government obtains more than half its tax revenue from this source. Of the American people's annual tax payments on their personal incomes, 93 percent is to the Federal Government, only 7 percent to State and local governments. The Federal payments, aggregating now about $50 billion, come from about 51 million families and single persons in all parts of the country; the $4 billion State and local payments probably come from about 25 million taxpayers living in about two-thirds of the States, which exclude some of the most industrialized high-income sections of the country.

The question before us is whether State and local governments should be encouraged to place greater reliance on this kind of tax. The case for doing so rests principally on these considerations:

1. The overriding fiscal problem of the States is their need for additional revenue and especially for a tax source that responds more than proportionately to economic growth. The personal income tax has a greater capability for producing an accelerating amount of revenue in response to rising economic activity than any other tax now in use.
2. Increased use of the income tax would permit lesser reliance on other taxes and enable State and local governments to spread their tax take among more taxes, thus permitting all tax rate levels to be minimized to reduce State vulnerability to and political leaders' concern with tax competition from other States.
3. Since the burden distribution of the income tax, unlike that of most taxes, can be predetermined, increased income tax use would enable political leadership to guide the distribution of a larger share of the State tax burden to accord with their voters' preferences.
4. The personal income tax provides the most effective way for exempting the disadvantaged members in American society—the poor—from some of the burden of State and local taxation. This fact takes on increasing importance as national policy objectives encompassed in the antipoverty program gain dominance, as the significance of the State and local sector in the total government operations increases and as the weight of national payroll taxes to finance social security programs grows heavier.
5. A greater reliance on the personal income tax would contribute to improving the fairness of State and local taxation also by permitting a larger share of the tax burden to be adjusted to the size of the family through an exemption system—a criterion typically disregarded by the property tax and violated by the sales tax. The unique ability of the income tax to treat individuals and households with equal income equally grows in importance as the margin between people's incomes and their consumer expenditures widens and as family homesteads become less and less indicative of taxpaying ability.

A case, however, can be made for the contrary position, in favor of the proposition that State income taxation should be kept at present relatively nominal levels. The arguments in favor of this position are these:

1. The National Government's freedom of tax action, especially important in times of emergency, should not be reduced by increased State dependence on income taxation. It will be recalled that Canada and Australia found it necessary "to buy out" their States' stake in the income tax to finance World War II.

2. States in quest of more rapid economic development may want to rely on indirect (consumer) taxes rather than direct taxes on personal incomes which tend to dull incentives. States concerned with revenue stability may have similar preferences.

3. Since the personal income tax is suited best to highly industrialized State economies, it cannot produce significant amounts of revenue efficiently for some States.

4. The States' freedom to pursue different tax policies is one of the cherished features of this federal system and should be fostered.

5. The more limited State taxation of income, the less the degree of State-Federal tax overlapping, and overlapping is incompatible with the people's preference for tax simplicity, for a clear separation of revenue sources among government levels.

In our judgment, the argument is in favor of expanding the role of personal income taxes in State-local tax systems. In arriving at this conclusion we have sought diligently to avoid the sales tax versus income tax issue. We decline to express ourselves on that pointless controversy. We hold this to be a fruitless debate from the longer run viewpoint because, as time progresses, States will be left with less and less freedom to choose between taxes; increasingly they will be obliged to use all of them.

Income and sales taxes, to be sure, have very different attributes. However, the States' need for revenue is so compelling as to overshadow even such significant differences among taxes as the pattern of their burden distribution. We have identified a variety of national policy objectives that can be realized only to the extent that the States (including their local governments) have the revenue to finance their share of them. Since many of these programs concentrate on improving the well-being of the less prosperous groups in the population, the benefits these groups stand to forego, if State and local governments default on these programs for lack of funds, loom large even in relation to the low-income group's stake in the difference between the tax burden patterns of different kinds of taxes.

We have noted with interest also that sales tax and income tax advocates are beginning to find some bases of reconciliation now that the usefulness and practicability of income tax credits for relieving the burden of sales taxes on low-income groups has been demonstrated (Indiana, Colorado, and Hawaii).

We appreciate also that the aversion to income taxation at the State level is in some ways associated with forebodings about its potential misuse for "soak the rich" and other nonrevenue objectives. It would appear, however, that the restraining influence exerted on State political leadership by the hard facts of interstate tax competition, limited State taxing jurisdiction, and mobility of business firms and people—factors of increasing influence since World War II—will tend to quiet public apprehensions about the possible misuse of personal income taxation by State legislators.

Recommendation No. 1. The Commission recognizes that the proper role of the personal income tax in a State's tax system must be determined by the State, for itself, on the basis of its revenue needs, resources, and its people's preference among types of taxes. The Commission, however, recommends for reasons stated in this report, that in formulating their tax policies, States without the personal income tax give early and careful consideration to incorporating it into their tax system and that those presently employing a relatively ineffective income tax strengthen it.[5]

THE FEDERAL ROLE IN THE STATE INCOME TAX MOVEMENT

Since the Federal Government's personal income tax collections are approximately 11 times greater than those of State and local governments, its income tax policies are critically important to any assessment of the future of the States' income taxes.

The historical evidence marshalled in chapter 3 supports the finding that heavy Federal use of the personal income tax, especially since 1940, has been the single most important deterrent to its expanded use by the States. It has enabled the opponents of State income taxation to win the day with the argument that the Federal Government has effectively "preempted" this tax; that, therefore, State and local governments must necessarily depend primarily on consumer, business, and property taxes.

We believe it to be significant that not a single State adopted a personal income tax between 1937 and 1960, when 12 States adopted general sales taxes. Although three new State income taxes have been added since 1960, approximately 95 percent of the nearly $4 billion currently collected from this source goes to jurisdictions that enacted it before 1938—over a quarter century ago. In contrast, only 68 percent of general sales tax revenue is collected by States that adopted this tax prior to 1938.

The Commission concludes that extensive use of the personal income tax by the Federal Government since 1940 has deterred the State personal income tax movement.

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[5] Senator Ervin, Senator Mundt, Governor Dempsey, and Congresswoman Dwyer dissent from this recommendation and state:

"We strongly disagree with the action which the Commission has taken here. It is up to each State to determine the degree to which, if any, it wishes to use the income tax as a source of revenue for the State government. Some States with good reason may decide not to use it at all; others with equally good reason may decide to use it extensively. In our view, the Commission majority is wrong on two points. First, one cannot generalize regarding whether a tax is good or bad for the Nation as a whole. For example, some States, taking into account the very heavy burden imposed by the Federal income tax, have chosen to try to lend some balance to the equation by an emphasis on consumption and property taxes.

"In the second place, we believe it is inappropriate for the Commission to presume upon the independence of State governments in suggesting the types of taxes which they employ. In our opinion, this recommendation which the majority of the Commission has chosen to adopt is not compatible with the Commission's tradition of objectivity and neutrality in the examination of questions of intergovernmental relations."

Congressman Fountain also dissents and states:

"I favor effective State use of the personal income tax as a productive source of revenue for strengthening State government. However, I am disassociating myself from this recommendation as stated because I believe it is likely to be misconstrued.

"Tax systems and conditions differ among the States and, as the Commission has observed, each State is best able to judge for itself which taxes are most appropriate for it. Accordingly, this recommendation could be viewed as gratuitous advice to those States which have chosen not to use the income tax, or to use it only lightly, due to local conditions and the Federal tax structure. I believe that the proper way to encourage greater State use of the personal income tax is by Federal tax incentives rather than exhortation."

This finding, together with our conclusion that the national interest would be served by expanded (or continued) State use of the personal income tax, as expressed in our first recommendation, brings us logically to the question whether the Federal Government should alter its tax treatment of State income tax payments so as to neutralize the deterrent effect of its heavy income tax on State use of this revenue source. The Federal Government now allows income taxpayers either to claim a 10 percent standard deduction (with minimum and maximum dollar limitations) or to itemize their State and local income tax payments as one of their allowable personal expense deductions.

A change in the Federal tax treatment of State income taxes would differentiate them from property, sales, and gasoline taxes on the ground that the National Government makes very intensive use of the income tax but taxes consumer expenditures only lightly and property not at all and that this deters State taxation of incomes. Since differentiation in tax treatment would give legislative recognition to the hypothesis that once the presently non-neutral effect of the Federal income tax on State tax policy is removed, State legislators would look with favor on the income tax because (*a*) it represents the last major source of untapped revenue, (*b*) it has unique revenue growth potential, and (*c*) it enjoys important advantages from the standpoint of tax fairness.

The analysis of alternative approaches to neutralizing the influence of Federal income tax policies on the taxing freedom of the States presented in chapter 6 suggests that the most feasible method for achieving this end is to allow a tax credit against Federal liability; that a tax credit of somewhere between 25 and 50 percent of income taxes paid to State and local governments would be required. A tax credit equal to about 40 percent of State income taxes would represent a middle course between overcompensation (90 to 100 percent credit) and undercompensation (the present rules). The standard deduction would not be changed.

Because of its high visibility, even a partial credit has great psychological value. Under the present deductibility system, the State income tax payment merely shows up as one itemized component of the State and local tax payments(alongside property, sales, and gasoline tax payments), which are subtracted from income (together with other personal expense items) in calculating the amount of taxable income subject to the tax rates. A tax credit, available to all taxpayers whether or not they itemize, would be identified as a separate item to be subtracted by all from the amount of tax otherwise payable. This would make State tax policymakers mindful of its special Federal tax-reduction value.

The income tax credit device is familiar to many taxpayers since it has been long employed for the handling of foreign taxes paid on income derived abroad and more recently, in the treatment of dividend and retirement income and to encourage plant investment. A Federal tax credit for income taxes paid to States, moreover, has been proposed from time to time for furthering various policy objectives. In the course of our current investigation we have explored the advantages and disadvantages of the credit device in considerable detail. We here

summarize both sides of the question to clarify the basis of our conclusions.

Clearly, a Federal credit for State income taxes would involve a continuing revenue cost to the U.S. Treasury, its amount depending upon its terms and upon the response of State legislatures. The range of probable costs can be estimated, however, within reasonably narrow limits.

Since the Federal Government already sustains a heavy revenue loss under the present deductibility system—every dollar of income tax collected by the States results in about a 24 cents reduction in Federal income tax liability—the *initial* cost of an optional credit plan would be less than is generally presumed. It is estimated that in terms of revenue foregone by the U.S. Treasury the cost of the present system of itemizing State income tax payments will reach about $1.1 billion by fiscal year 1967. The comparable revenue cost of an optional 40 percent credit for the same year would be about $1.8 billion. Thus, the additional 1967 cost attributable to the credit would be approximately $700 million. The comparable estimate for a 33 percent tax credit is about $500 million.

On the basis of a very liberal assumption about the effect of a 40 percent tax credit on State legislation, i.e., that all States would immediately enact individual income taxes with a yield equivalent to 2 percent of Federal AGI less personal exemptions (the corresponding equivalent in 1963 was 1.2 percent), the additional cost in terms of Federal revenue foregone would approach $2 billion in fiscal year 1968. This Federal cost would be associated with approximately $7.5 billion of State income tax collections. In the absence of such a credit, State collections can be expected to rise to $4.8 billion. Thus, a $2 billion Federal revenue loss would be matched with a $2.7 billion State revenue gain.

In a sense, the introduction of a Federal credit for State income taxes would discriminate in favor of Federal taxpayers residing in income tax States and against those in the States that rely upon other revenue sources. It would have this result if most of the non-income-tax States continued to refrain from income taxation; if the credit did not achieve its end. However, the very threat of such discrimination would tend to make it short lived. By making the effective date of the credit provision prospective, say two to four years after the date of enactment, Congress would afford legislatures (and the electorate) in the non-income-tax States an opportunity to enact a personal income tax, to safeguard their constituents against discriminatory Federal tax treatment. Similarly, legislatures in States with operating income taxes would have ample opportunity to consider rate increases to absorb all or part of the prospective Federal tax credit. We are confident that this is the course State legislatures would elect because the pressure for added revenue is unrelenting. Indeed, it is for this reason we believe it unnecessary to couple such a credit with a requirement for corresponding increases in State incomes taxes, a revenue maintenance provision of the kind we proposed in connection with increasing the Federal estate tax credit.

Some are of the opinion that it is unnecessary for the Federal Government to incur a revenue cost for the purpose of encouraging greater State use of the personal income tax because the growing fiscal crisis at the State level will eventually force most States to use this last major source of untapped revenue anyhow; that the recent Federal tax reductions will speed this development. We are not so confident. Many of the non-income-tax States will continue to be hobbled by their relatively inelastic tax structure in the foreseeable future unless income taxation is accorded some additional support. Since political leadership tends to regard any decision to impose a new general tax on the public as a last resort, non-income-tax States can be expected to exploit less controversial revenue sources before adopting a personal income tax. Three years have elapsed since Federal tax reduction to stimulate the economy was first injected into public discussion on a large scale. During that period legislatures in many States faced tax increases. Significantly, none was urged to increase income taxes on the ground that Federal taxes were being reduced.

We have considered also the view that preferential tax treatment for State personal income tax payments would violate the concept of Federal neutrality as the general public understands it and would undermine State autonomy in decisionmaking on taxes. Such departure from neutrality, however, would be more apparent than real, since in a sense the present system, dating from 1913, lost its neutral character when the Federal Government turned to primary reliance on the individual income tax during World War II.

The possibility can not be overlooked that preferential treatment of State income taxes would trigger demands upon the Congress for comparable treatment of sales and property taxes. The basic objective of the plan to encourage State income taxes would be nullified, of course, if Congress heeded these demands. Congress need not do so, however, for as we have already noted the income tax can be distinguished from the others on the ground that while the Federal Government preempts a large share of personal incomes, it taxes neither general sales nor property.

It will be noted that we leave open the percentage rate at which State income tax payments should be credited against Federal tax liability, believing this to be a matter for congressional consideration on the basis of public hearings. Some will hold that political and economic circumstances vary so widely among the States that preferential tax treatment of State income taxes pegged at any reasonable level will overcompensate for the deterrent effects of the heavy Federal income tax in some States and undercompensate for it in others. Admittedly, the science of public finance is not sufficiently exact to tell us the precise amount of inducement that will just be sufficient to compensate for the deterrent effect of heavy Federal taxes. Reasonable inferences can be drawn, however, from historical experience. Clearly, a 90- to 100-percent credit would tip the scales completely in favor of State income taxation. No State could refrain from financing most of its needs by writing drafts on the U.S. Treasury. It is equally clear that the present deductibility system (equal, on the average to a

24-percent Federal credit for all deductible taxes) makes inadequate compensation for the high Federal rates and that, as a consequence, Federal tax policy tips the scales in favor of State and local consumption and property taxes. This suggests that a partial credit in the 25- to 50-percent range would come close to steering a middle course between undercompensation (the present situation) and overcompensation (a 100 percent or full credit). The precise rate required is appropriately an issue for legislative resolution.

We have considered the possibility of postponing consideration of the States' need for more effective income taxes pending completion of a comprehensive study of the whole State and local fiscal system and of the alternatives available to the Federal Government for relieving the financial burdens of State and local governments and concluded against counseling delay. It is clear to us that no comprehensive study of the ways in which the Federal Government can use its resources in aiding State and local governments can override the hard logic that the States should be encouraged to exploit their own tax resources before Congress considers the introduction of large-scale general-purpose aid programs.

These are the principal considerations underlying our conclusion in favor of the Federal income tax credit. We believe that such a credit would facilitate more effective State use of personal income taxation and, by improving the States' ability to solve their fiscal problems with their own resources, would help to reinforce their independence and thereby strengthen this Federal system.

Recommendation No. 2. The Commission concludes that extensive use of the Federal personal income tax since 1940 has retarded the State personal income tax movement and that this deterrent effect should be neutralized in order to enable the States to help themselves before Congress is asked to consider other general forms of Federal financial aid. The Commission recommends, therefore, that the Congress amend the Internal Revenue Code on a prospective basis to give Federal income taxpayers an option to either (a) continue itemizing their income tax payments to State and local governments or (b) claim a substantial percentage of such payments as a credit against their Federal income tax liability.[7]

THE CONFORMITY ISSUE

The proposition that revenue sources should be clearly separated by an arrangement which would reserve the income tax for the Federal Government, sales taxes for the States, and the property tax for local governments has long had widespread support. Confronted with the

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[7] Secretary Fowler expresses the following reservation:

"I have not voted on this recommendation. At the present time I am clear I cannot vote in favor of it. But since important issues are involved, I do not desire to vote against it. I would prefer that the matter be given wider study and discussion. It represents in effect a method of providing Federal financial assistance to State and local governments. Alternative methods to this end have been suggested by others. All of these alternatives involve a very substantial commitment of Federal funds and for that reason require careful public discusssion."

Governor Dempsey abstains from this recommendation.

hard fact of tax overlapping in the income tax field, however, many have tended to support the view that State personal income tax laws should conform as closely as possible to the Federal Internal Revenue Code, in order to minimize inconvenience to taxpayers and administrative costs. If taxpayers convenience and administrative efficiency can not be secured by separation of revenue sources, then a policy of conformity is acceptable as a "second best" method.

Two basic questions are involved in the conformity issue:

Should the States be encouraged to conform their tax laws more closely to the Federal income tax?

If more extensive conformity is desirable, how much farther down the path to conformity should the States go?

Although considerations of taxpayer convenience and administrative efficiency support a substantial degree of conformity to the Federal income tax, several other factors must also be weighed in the balance. Conformity involves a limited delegation of State sovereignty, the effects on State revenues can not be overlooked, and conformity builds into the State law the bad features of the Federal income tax along with the good.

It is our judgment that an attempt to exercise independence with respect to the definition of net income derived from business and professional activity would be misguided, because the basic questions in this area are best resolved in accord with the rules of good business practice, which presumably do not vary significantly from State to State. The major issue is what should be allowed as a cost for doing business, and the rules of sound accounting practices must necessarily prevail. The definition of net income from business operations is, in fact, largely an exercise in articulating the rules of accountancy.

The Commission concludes that State personal income tax laws should provide for the deduction of the "ordinary and necessary" expenses of earning income as they are defined in the Federal Internal Revenue Code, and that the expenses of employees should be deductible in the same way as the expenses of those carrying on a trade or business.

We turn next to consideration of the extent to which State laws should conform to the Federal income tax. Apart from the rather theoretical possibility of pursuing a totally independent course (the first of listed alternatives) a State can follow one of five basic alternatives:

Rank order and degree of conformity	Description	Form 1040 correspondence
1. None	Complete independence from Federal provisions.	None.
2. Minimum	Conformity with respect to particular exclusion and deduction provisions.	Selected line items.
3. Moderate	Conformity to Federal adjusted gross income (total income after "cost" adjustments) and before personal exemptions and deductions.	Line 9.
4. Extensive	Conformity to Federal net income before personal exemptions.	Line 11b.
5. Very extensive	Conformity to Federal taxable income	Line 11d.
6. Complete	The State tax base is the Federal tax liability	Line 16.

FORM 1040 — U.S. Treasury Department, Internal Revenue Service

U.S. INDIVIDUAL INCOME TAX RETURN—1964

or taxable year beginning .... 1964, ending .... 19 ....

Your social security number (Husband's if joint return)

Please Print or Type

First name and initial (If joint return, use first names and middle initials of both) | Last name | Occupation

Home address (Number and street or rural route) | Wife's number, if joint return

City, town or post office, and State | Postal ZIP code | Occupation

Enter the name and address used on your return for 1963 (if the same as above, write "Same"). If none filed, give reason.

NOTE.—Married taxpayers: If you are changing from filing separate returns to a joint return or from a joint return to separate returns, enter names and addresses from the 1963 joint or separate returns.

See instructions before completing your return.

FILING STATUS—check one:

1a. ☐ Single
b. ☐ Married filing joint return (even if only one had income)
c. ☐ Married filing separately. If your husband or wife is also filing a return give his or her first name and social security number.
d. ☐ Unmarried Head of Household
e. ☐ Surviving widow(er) with dependent child

EXEMPTIONS

2a. Regular ☐ Yourself ☐ Wife
b. Age 65 or over ☐ Yourself ☐ Wife
c. Blind ☐ Yourself ☐ Wife
Enter number of boxes checked →
3a. Number of your dependent children *who lived with you*
b. Number of other dependents (from line 3, Part I, page 2)
4. Total exemptions claimed →

Attach Copy B of Form W-2 Here

INCOME—If joint return, include all income of both husband and wife

5. Wages, salaries, tips, etc. If not shown on attached Forms W-2 attach explanation ..... $
6. Other income (from line 9, Part II, page 2) .....
7. Total (add lines 5 and 6) .....
8. Adjustments (from line 5, Part III, page 2) .....
9. Total income (subtract line 8 from line 7) .....

FIGURE TAX BY USING EITHER 10 OR 11

TAX COMPUTATION

10. Tax Table—If you do not itemize deductions and line 9 is less than $5,000, find your tax from tables in instructions. Do not use lines 11 a, b, c, or d. Enter tax on line 12.
11. Tax Rate Schedule—
a. If you itemize deductions, enter total from Part IV, page 2 .....
If you do not itemize deductions, and line 9 is $5,000 or more enter the larger of:
(1) 10 percent of line 9 or;
(2) $200 ($100 if married and filing separate return) plus $100 for each exemption claimed on line 4, above.
The deduction computed under (1) or (2) is limited to $1,000 ($500 if married and filing separate return).
b. Subtract line 11a from line 9 .....
c. Multiply total number of exemptions on line 4, above, by $600 .....
d. Subtract line 11c from line 11b. (Figure your tax on this amount by using tax rate schedule on page 10 of instructions. Enter tax on line 12.) .....

TAX—CREDITS—PAYMENTS

Attach Check or Money Order Here

12. Tax (from either Tax Table, line 10, or Tax Rate Schedule, line 11) .....
13. Total credits (from line 5, Part V, page 2) .....
14. Income tax (subtract line 13 from line 12) .....
15. Self-employment tax (Schedule C-3 or F-1) .....
16. Total tax (add lines 14 and 15) .....
If either you or your wife worked for more than one employer, see page 5 of instructions.
17a. Total Federal income tax withheld (attach Forms W-2) .....
b. 1964 Estimated tax payments .....
(Include 1963 overpayment allowed as a credit) (Office where paid)
c. Total (add lines 17a and 17b) .....

TAX DUE OR REFUND

18. If payments (line 17c) are less than tax (line 16), enter Balance Due. Pay in full with this return. →
19. If payments (line 17c) are larger than tax (line 16), enter Overpayment →
20. Amount of line 19 you wish credited to 1965 Estimated Tax .....
21. Subtract line 20 from 19. Apply to: ☐ U.S. Savings Bonds, with excess refunded; or ☐ Refund only .

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete. If prepared by a person other than taxpayer, his declaration is based on all information of which he has any knowledge.

SIGN HERE → .... If joint return, BOTH HUSBAND AND WIFE MUST SIGN even if only one had income. .... Date

Sign here .... Signature of preparer other than taxpayer .... Address .... Date

16—76464-1

FORM 1040 - 1964 Page 2

PART I.—EXEMPTIONS Complete only for dependents claimed on line 4b, page 1

(a) NAME (If more space is needed attach schedule)	(b) Relationship	(c) Months lived in your home. If born or died during year write "B" or "D"	(d) Did dependent have income of $600 or more?	(e) Amount YOU furnished for dependent's support. If 100% write "ALL"	(f) Amount furnished by OTHERS, including dependent
1.				$	$
2.					

3. Total number of dependents listed above. Enter here and on line 4b, page 1 →

PART II.—INCOME FROM ALL SOURCES OTHER THAN WAGES, SALARIES, ETC.

Dividends and Other Distributions

A. Gross amount
B. Nontaxable and capital gain distributions
C. Subtract item B from item A. Give details in lines 1a through 1d

Explanation of Item C (Write (H), (W), (J) for stock held by husband, wife, or jointly)

1a. Qualifying dividends (Name of payer)

Total

b. Subtract $100. If joint return see instructions
c. Balance
d. Nonqualifying dividends (Name of payer)

Total

2. Total (add lines 1c and 1d) →
3. Interest (Name of payer)

Total interest income →

4. Pensions and annuities, rents and royalties, partnerships, and estates or trusts (Schedule B)
5. Business income (Schedule C)
6. Sale or exchange of property (Schedule D)
7. Farm income (Schedule F)
8. Other sources (state nature)

Total other sources →

9. Add lines 2 through 8. Enter here and on line 6, page 1 →

PART III.—ADJUSTMENTS

1. "Sick pay" if included in line 5, page 1 (Attach Form 2440 or other required statement)
2. Moving expenses (attach Form 3903)
3. Employee business expense (attach Form 2106 or other statement)
4. Payments by self-employed persons to retirement plans, etc. (Attach Form 2950SE)
5. Total adjustments (lines 1 through 4). Enter here and on line 8, page 1

EXPENSE ACCOUNT INFORMATION—If you had an expense allowance or charged expenses to your employer, check here ☐ and see page 7 of Instructions.

PART IV.—ITEMIZED DEDUCTIONS—Use only if you do not use tax table or standard deduction.

Medical and dental expense.—Attach itemized list. Do not enter any expense compensated by insurance or otherwise. NOTE: If you or your wife are 65 or over, or if either has a dependent parent 65 or over, see page 8 of instructions for possible larger deduction.

1. Enter excess, if any, of medicine and drugs over 1% of line 9, page 1
2. Other medical, dental expenses (include hospital insurance premiums)
3. Total (add lines 1 and 2)
4. Enter 3% of line 9, page 1 (see note above)
5. Subtract line 4 from line 3; see page 8 of instructions for maximum limitation

Contributions.—If other than money, attach required statement—see instructions.

Total (see instructions for limitations) →

Interest: Home mortgage

Other (Specify)

Total interest expense →

Taxes—Real estate
State and local gasoline
General sales
State and local income
Personal property

Total taxes →

Other deductions (see page 9 of instructions)

Total other deductions →

TOTAL DEDUCTIONS (For line 11a, page 1) →

PART V.—CREDITS

1. Dividends received credit: Enter smallest of (a) 2% of line 1c, Part II, (b) tax shown on line 12, page 1, less foreign tax credit, or (c) 2% of taxable income (see instructions).
2. Retirement income credit (Schedule B)
3. Investment credit (Form 3468)
4a. Foreign tax credit (Form 1116)
b. Tax-free covenant bonds credit
5. Total credits (add lines 1 through 4b). Enter here and on line 13, page 1

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A detailed discussion of the relative advantages of the alternative conformity policies appears in chapter 7. The Commission believes that the following criteria are relevant to a choice among them:

1. The policy should maximize taxpayer convenience and minimize administrative costs;
2. It should enable a State to collect substantial revenues with relatively low tax rates and therefore should employ the broadest possible tax base;
3. Taxpayers with equal abilities to pay taxes should be treated equally; in technical terms, the definition of taxable income should be "horizontally equitable";
4. The approach should not restrict a State's freedom to establish its own rate structure and personal exemptions; and
5. The approach should minimize the likelihood of adverse effects on State tax revenues resulting from foreseeable changes in Federal tax policy.

The first criterion alone is sufficient to rule out the first two listed alternatives. Some meaningful gains in taxpayer convenience could be obtained by an extension of conformity with respect to particular exclusions and deductions, but only alternatives 3 through 6, those embraced in the range from moderate to complete conformity, are relevant if a real breakthrough in taxpayer convenience and administrative economy is desired. As far as taxpayer convenience and administrative costs are concerned, alternatives 3 through 6 all are quite satisfactory. A single figure from his Federal tax return would be enough to complete most of a taxpayer's State return under any one of the approaches.

If the largest possible State tax base is sought, the highest rating must be given to the adjusted gross income base (alternative 3). Federal adjusted gross income is over 75 percent larger than Federal taxable income. Even Federal adjusted gross income could be substantially increased by the inclusion of such classes of income as unemployment compensation, sick pay, and the 50 percent of long-term capital gains that is excluded by the Federal Code. Many States presently include these items in taxable income. Modification of Federal adjusted gross income by requiring the addition of such classes of income could increase the Federal figure by as much as 10 or 15 percent.

The Internal Revenue Code has come under increasing criticism in recent years for its special provisions that impair the equal treatment of taxpayers with equal incomes. Most of these inequities result from personal deduction provisions, which discriminate against renters and those who pay cash for their television sets and washing machines—to cite two examples. Since many of the inequities could be avoided by not conforming to Federal taxable income, the criterion of equity also provides a basis for preferring adjusted gross income (alternative 3). Indeed, a regard for tax fairness reinforces the revenue case for raising the Federal figure by including in the State tax base certain classes of income that are excluded from Federal adjusted gross income. To the extent that Federal personal deduction provisions are designed to serve social policy objectives—such as encouraging charitable contributions—it is doubtful that State tax considerations will have an effect on individuals' plans that begins to match the cost

to the State in lost tax base. Only alternative 6, that is, when the Federal tax is the base for the State tax, would preclude a State from enacting exceptions to any of the Federal definitions whenever considerations of equity or social policy appear to that State to be worth the revenue loss.

Under any of the four alternatives—3 through 6—a State is free to set its own tax rates, but only under alternatives 3 and 4 does a State reserve the right to define its own personal exemptions. Theoretically, adoption of the Federal tax liability as the State tax base—alternative 6—leaves a State free to establish a rate structure that yields a progressive, regressive, or proportional distribution of the State tax burden. Given that Federal tax liabilities are progressively distributed, however, a flat-rate State tax defines a degree of progressivity that parallels the Federal. Since State rates that appear to *decline* as a taxpayer's Federal income tax rises are unlikely to have much political appeal, adoption of alternative 6 probably would tend to commit a State to a flat percentage relationship to Federal tax liability and to a burden distribution that parallels the progressiveness of the Federal tax.

Recommendation No. 3. The Commission recommends that the States endeavor to bring their income tax laws into harmony with the Federal definition of adjusted gross income, modified to allow the deduction of individuals' income earnings expenses and for such additions to the tax base as considerations of base broadening and equity make feasible.[8]

FEDERAL-STATE ADMINISTRATIVE COOPERATION

Americans take justifiable pride in the opportunity their Federal system affords for experimentation at the State level with alternative approaches to the solution of governmental problems. The diffusion of political responsibilitiy affords the opportunity to test new ideas in limited geographic areas. The personal income tax, which preoccupies us in this report, was first pioneered in its modern version, it should be remembered, by a State (Wisconsin), not the Federal Government.

Now that 20 to 25 million families and single persons pay both Federal and State income taxes and even a larger number *file* two tax returns, a first-rate opportunity exists to advance taxpayer convenience and administrative simplification, provided that both Federal and State tax policymakers can create an environment hospitable to administrative innovation and experimentation. The potential benefits of Federal-State administrative cooperation will become even greater as more States move into income taxation.

Since World War II, and more particularly after 1950, considerable progress has been made in administrative cooperation, as exemplified by the conclusion of formal agreements between the Federal Government and the States for coperative exchange of tax information, by the availability of Federal statistical services to the States, and by the provision of machinery to enable State tax enforcement personnel to participate in training programs conducted by the Internal Revenue Service (ch. 7). These arrangements are only beginning to be

[8] Governor Dempsey abstains from this recommendation.

utilized and their use will undoubtedly be expanded as their potential benefits come to be more widely appreciated.

However promising these efforts in Federal-State cooperation, we regard them at best to be tentative first steps toward maximizing taxpayer convenience and administrative efficiency. To date, the progress has been chiefly in the direction of strengthening the enforcement arm of the State. To the extent that the taxpayer's filing process has been made more convenient, it stems less from intergovernmental cooperation than from State legislatures' efforts to conform their personal income tax laws to Federal Revenue Code definitions.

The ultimate objective of Federal-State income tax comity—one contemplated by some planners as early as the 1930's—is a condition that would enable the taxpayer to satisfy both State and Federal filing requirements with a single tax return. We are not unmindful of the differences between the State and Federal constitutional taxing powers with respect to some sources of income, but such differences as are essential can be handled in the relatively few cases affected by adjustments within a combined Federal-State return. Conceivably, both governments' taxes could ultimately be collected by the Federal Internal Revenue Service. The realization of such a goal, however, is unlikely without State and Federal authority to experiment on a limited geographic basis.

Federal collection of State personal income taxes could be implemented at any one of four successive stages of tax administration:

1. Withholding of income tax at the source;
2. The taxpayer's declaration of estimated income;
3. Initial arithmetic verification of the taxpayer's return by the Internal Revenue Service; or
4. Audit of the taxpayer's return by the Internal Revenue Service.

Joint handling of both State and Federal tax returns up to the arithmetic verification (3) or the audit (4) stage would ease taxpayers' compliance burdens materially because a single annual return with the Internal Revenue Service would discharge both the Federal and State obligations. Employers would benefit from a substantial reduction in paper work if withheld State and Federal taxes could be handled in a single remittance. State tax agencies would gain in improved taxpayer compliance and in substantial administrative economies.

Obviously, it would be fairly simple for the Internal Revenue Service to collect State income taxes if they were all tied uniformity to the Federal tax base and the rules of State taxing jurisdiction were simplified and standardized. Still, the versatility afforded by comprehensive and sophisticated data processing systems will facilitate handling many kinds of interstate variations. However, the electronic computer can function only on the basis of information fed into it. It cannot resolve the kind of legal, administrative, and political problems inherent in the construction of a combined Federal-State collection system. We have in mind, for example, the absence of a uniform definition of residency, the multistate origin of income, the mobility of taxpayers, and the varying concepts of State taxing jurisdiction.

Serious political problems are also raised by a proposal to "farm out" the collection of State income taxes to the Internal Revenue Serv-

ice. On general principles, many persons would take the view that the benefits to be derived in the form of greater taxpayer convenience and administrative efficiency would be far outweighed by the loss of absolute State control over the collection process and the consequent aggrandizement of the Federal bureauracy.

If Federal collection were applied at the withholding (1), the declaration (2), or the arithmetic verification (3) stage, the Internal Revenue Service would be acting only in an administrative capacity. States would not necessarily be required to change their tax structures significantly. Presumably, their tax sovereignty would not be jeopardized because they would retain the ultimate administrative and political responsibility, both for determining the amount of the tax and for final adjudication of taxpayer liabilities. Only if the combined State-Federal administration carried all the way through the audit (4) stage would a State actually "farm out" final determination of taxpayer liability to the Internal Revenue Service.

Because of the political ramifications and administrative problems involved in Federal collection of State income taxes, any experimentation in this field would of necessity have to be on an optional basis. State political leaders would have to weigh the benefits to be derived—greater taxpayer convenience, administrative simplification, improved compliance—against the loss of States' control over their collection system. By the same token, the Internal Revenue Service would want to retain its freedom to prescribe the conditions necessary to enable it to undertake such an activity.

The crucial point to be underscored is this: Both the States and the Internal Revenue Service should be given the legal authorization to enter into tax collection agreements because without it experimentation with Federal collection of State income taxes is effectively prevented. It is our expectation that, armed with this kind of authority, a State considering the adoption of a personal income tax for the first time might well be receptive to the idea of utilizing the Federal collection apparatus at the withholding stage or even to the point of mathematical verification, and would therefore be willing to construct its laws so as to meet the reasonable requirements of the Internal Revenue Service for this kind of undertaking.

Recommendation No. 4. The Commission recommends that in order to encourage experimentation with Federal collection of State income taxes, the Congress authorize the Internal Revenue Service, and that the legislatures of States using personal income taxes authorize their Governors, to enter into mutually acceptable agreements for Federal collection of State income taxes.[9]

STATE TAXING JURISDICTION

It is a well-established principle of income tax jurisdiction that a State can tax all the income of its residents, wherever derived, as well as that portion of a nonresident's income that originates within its borders. The objective of holding a resident accountable for all of his income wherever derived has logic in its favor in that the income tax is a personal tax and liability under it should properly reflect the tax-

[9] Governor Dempsey abstains from this recommendation.

payer's total personal income. The taxation of nonresident income recipients, on the other hand, recognizes that the State of employment incurs various public costs in providing and developing employment opportunities. Since many individuals obtain at least part of their income from out-of-State sources, the simultaneous use of both jurisdictional rules can result in double taxation except to the extent that it is prevented by a system of tax credits.

In the usual situation, an individual who resides in one income tax State and derives income from another is granted a tax credit by his own State for the income tax he pays to the other State. For example, if he earns all of his income in the other State, and his tax liability to his own State is equal to or less than his liability to the other State, he will pay a tax only to the other State; if his own State imposes a heavier income tax than the other, he will pay the difference between the two tax liabilities to his State of residence (having paid the other State the amount he owes it under its rate structure).

Thirteen States use a different approach. In addition to allowing a credit to residents who are required to pay income taxes to another State, they either allow a credit to nonresidents or exempt them from the income tax, provided their own State reciprocates. In these circumstances, a resident of one such reciprocating State deriving income from another is relieved of any nonresident tax where the reciprocating States *exempt* nonresident income (that is, his total tax is paid to his own State). Where the reciprocal agreement is in the form of a nonresident *credit* and the State in which the taxpayer earns his income levies a higher tax than does his own State, he pays only the difference between the two tax liabilities to the former (having paid his own State the amount he owes it under its rate structure).

While both crediting devices prevent double taxation, they have opposite effects on the distribution of tax revenue derived from interstate income. When a State grants a credit to its residents and not to nonresidents, it is voluntarily shifting all or part of its residents' tax liability on out-of-State income to the State where that income is earned, while retaining the tax on nonresidents' income derived within its borders. States reciprocally crediting nonresidents with taxes they pay to their own States or exempting nonresidents' income from taxation shift the nonresidents' tax back to their State of residence, while retaining the whole tax of their residents no matter where their income is derived.

There are a number of arguments in favor of the prevailing system of allowing resident credits for income taxes paid to other States:

1. The resident credit ties into withholding systems operating in virtually all States, for it recognizes the fact that an employer can be required to withhold taxes for the States in which his business is located while he cannot be required to do so by another State, unless he also operates in that State. With a nonresident credit or exemption of nonresidents' income from taxation, the tax liability is to the State of residence which cannot enforce withholding of its tax from the income of its residents in another State. The resident State can, of course, require its taxpayers to make a declaration of estimated income, but it loses the administrative advantage of withholding at the source. It is

for this reason that a number of States have relinquished their nonresident credit since adopting withholding.

2. Our Recommendation No. 4, that the Internal Revenue Service be authorized to experiment with Federal collection of State personal income taxes, reflects our expectation that it should be possible ultimately to move toward a combined Federal-State system of personal income tax administration. Since withholding at the source is the backbone of both Federal and State tax enforcement, that objective can be attained only if withholding can be applied at the source of income, regardless of the taxpayer's State of residence.

3. When a State provides a nonresident credit, it tempts bordering non-income-tax States to shift part of its personal income tax revenue to themselves. Until 1961, New York was among those States that allowed a nonresident credit. This credit entailed very little revenue cost to New York at that time since its major bedroom communities were in New Jersey and Connecticut, neither of which levied an income tax. New Jersey tried to capitalize on this situation by levying a "commuters' income tax" which would have drawn about $30 million from the New York income tax paid by New Jersey residents. To avoid that loss, New York dropped its nonresident credit.

4. At one time, when industry was concentrated in a few States, the resident credit device favored the industrial States. With many more in commuters than out-commuters, it was to their advantage to tax nonresidents, leaving it up to those individuals' States to adjust for double taxation by allowing them a resident credit. The progressive industrialization of more and more States and the greater incidence of interstate commuting is rapidily changing this picture. As the number of commuters moving in both directions across State lines is better balanced, the revenue advantage of taxing nonresidents will be minimized.

The disadvantage of the credit system (whether it is applied to residents or nonresidents) is the burden it places on the taxpayer. Under a credit system, the taxpayer with out-of-State income must file tax returns in two States—his own and the one in which he derives his income—if both levy a personal income tax. In many instances, such a taxpayer owes taxes to both States. Since his employer will have withheld the nonresident State's tax, the taxpayer may well have to apply for a refund from that State at the same time that he pays some amount to his own State. A half-dozen States have moved to eliminate this source of taxpayer irritation by exempting a nonresident's income from their taxes if his State accords their residents like treatment. In these instances, the employer is also relieved of withholding the tax, since the residence State cannot enforce withholding upon the employer in the nonresidence State. As a result, the State of residence has to rely on obtaining a declaration of estimated income from the taxpayer, making enforcement more difficult. It is sometimes possible to arrange for voluntary withholding, as was done in the Maryland-District of Columbia-Virginia area with the cooperation of Federal agencies. In general, however, unless a firm operates in all States that enter such an agreement, it is hardly likely that this arrangment can be applied to a private employer.

The advantage of eliminating double filing inherent in the credit system by exempting the income of a nonresident from a State's personal income tax is outweighed, in our view, by the administrative advantages to be derived from a uniform system of resident credits to avoid double taxation.

Recommendation No. 5. The Commission recommends, therefore, that all States continue to allow credits to their residents for personal income taxes they pay to other States and that those States that now allow a nonresident credit repeal such nonresident provision.[10]

DEFINITION OF "RESIDENCE"

Although the present system of credits minimizes double taxation, there are some gaps because States define a "resident" in different ways. Thus, an individual could be considered a resident of two States during the same period of time as a result of conflicting legal definitions or conflicting interpretations of those definitions. Conversely, it is possible to evade State income taxation by deft manipulation of residence definitions.

Some States define "residence" an "domicile" or "permanent place of abode," without specifying a time period during which an individual is required to be in such status to be considered a resident. Others set forth detailed specifications, including different time periods. These variations result in time-consuming administrative annoyances to State tax officials.

Several States, like California and Arizona, consider an individual is a resident of the State if he "is in this State for other than a temporary or transitory purpose" or if he "is domiciled in this State" but is outside the State for a temporary or transitory purpose." New York uses a somewhat more precise definition in that it provides for a minimum length of time an individual must have spent in the State during a taxable year to be considered a resident (the specified time period depending upon whether or not he maintained a "permanent place of abode.") This Commission believes that some such definition (either the California or the New York type) applied uniformly by all the States, would avoid some of the problems now faced by State tax administrators. Admittedly, some problems would still remain, as in the case of individuals who maintain "permanent" residences in two or three States. By and large, however, a taxpayer could only be considered a resident of one State during any period of time under such a definition.

The absence of a uniform definition of "residence" brings to mind the problems associated with the divergent State rules for the allocation of income from interstate commerce. Because the States have not been able to agree on a single, uniform allocation formula, the Congress has been petitioned to prescribe such rules for them. We regret the need for such Federal action, as do State tax administrators but, in the absence of vigorous action on the part of the States, see no legal basis for questioning it.

The "residence" problem in the personal income tax field is a much simpler one and the States should be able to cooperate in arriving at an acceptable solution.

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[10] Governor Dempsey abstains from this recommendation.

Recommendation No. 6. The Commission recommends that the States adopt the following definition of "residence":

> *A resident individual means an individual: (a) who is domiciled in this State, unless he maintains no permanent place of abode in this State, maintains a permanent place of abode elsewhere, and spends in the aggregate not more than 30 days of the taxable year in this State; or (b) who is not domiciled in this State but maintains a permanent place of abode in this State and spends in the aggregate more than 183 days of the taxable year in this State.*

The Commission recommends further than the State tax agency be authorized to enter into reciprocal agreements to eliminate potential double taxation that might result from conflict in interpretation of the residence rule.[11]

STATE-LOCAL RELATIONSHIPS

Local governments in six States (Alabama, Kentucky, Missouri, Michigan, Ohio, and Pennsylvania) impose income taxes (ch. 4). The first three-mentioned States levy also State personal income taxes at low to moderate rates, but the number of their localities using income taxes is quite limited.

Michigan, Ohio, and Pennsylvania, none of which levies a State personal income tax, have permitted local income taxation to proliferate. This is particularly true in Pennsylvania, where almost 2,000 cities, boroughs, townships, and school districts have enacted local income taxes, and in Ohio where about 100 city income tax ordinances are in force. Although only few Michigan cities now use income taxes, the 1964 legislation authorizing uniform city income taxes will undoubtedly spur many more local enactments. About $350 million is now being produced annually from the local income taxes in the three States: $200 million in Pennsylvania, $100 million in Ohio, and $40 to $50 million in Michigan.

Any proposal for a State personal income tax inevitably raises the question of sharing the proceeds with local governments. That issue will be particularly controversial in States where local governments already collect income taxes. Should the State allow the local taxes to continue and adopt a third overlapping income tax? Or should the authority for local income taxes be replaced somehow from the proceeds of the new State tax?

This Commission has already gone on record with regard to the uncoordinated proliferation of local nonproperty taxes. In the report, *State Constitutional and Statutory Restrictions on Local Taxing Powers*, we urged the States to adhere to the following basic principle in granting nonproperty taxing powers to their local governments:

> Most local governments are smaller than the economic area in which they participate and therefore are handicapped in individually making use of income, sales, excise, and similar nonproperty taxes. Accordingly, local governments should be enabled to use these taxes only where required in the interest of the desired distribution of the combined State-local tax burden among the

[11] Governor Dempsey abstains from this recommendation.

several bases of taxation (property, income, consumption, and business activity), and more specifically, only where increasing demands for local services cannot be reasonably met from available property tax sources or where property already bears an inordinate share of the local tax burden. Where these conditions necessitate the use of nonproperty taxes by local governments, it is incumbent upon the State to help those local governments to overcome the handicaps which necessarily attach to independently administered nonproperty taxes.

Basically, insofar as the personal income tax is concerned, our preference is for a State, rather than a locally imposed, tax. Nevertheless, we recognize that political philosophies differ among States, and each will make its decision according to that philosophy. No matter what the decision, however, it should take advantage of the coordinating possibilities that a State income tax will open up.

Obviously, the most effective way to coordinate State and local personal income taxes is to impose and administer such a tax at the State level. The State can then distribute a portion of the tax to its local governments by: (1) returning to each locality a specific percentage of the amount collected within its jurisdiction; (2) using a portion of the tax revenue as an equalizing grant to be used by local governments as they see fit (including the reduction of property taxes); or (3) increasing the amounts distributed under grant-in-aid programs for particular purposes. In a strict construction sense, each of these devices can be said to impair somewhat local independence, for the State legislature can change the percentage it is willing to share, it can change an equalization formula, and it can impose conditions as to the local use of the funds. There is no "best" way for distributing State funds to local governments and the Commission offers none at this time. The resolution of that problem is subject enough for a separate study of State-local fiscal relationships.

If States like Michigan, Ohio, and Pennsylvania decide to continue local income taxation in conjunction with a State personal income tax, they should adhere to the following guidelines, generally applicable to local nonproperty taxes, which we have already set forth in the aforementioned report: (1) provisions relating to the use of nonproperty taxes should be statutory rather than constitutional, and they should be specific as to the kinds of taxes authorized, the particular local governments authorized to use them, their structure (tax base, exemptions, etc.), and administration; (2) the electorate should always have the authority to initiate by petition a vote on proposals for new nonproperty taxes; (3) the case for most nonproperty taxes is strongest in the large urban places; and (4) where a particular tax, such as the sales or income tax, is in widespread use by local governments and is simultaneously used also by the State, the most promising coordinating device is the local tax supplement to the State tax.

The Michigan "Uniform City Income Tax Act," which adheres closely to the first three guidelines, could be adapted very readily to the piggyback idea contemplated by the fourth guideline should a State decide to adopt a statewide personal income tax. It also mitigates some of the regressive sting and inequitable features to be found in most of the existing local income taxes by allowing personal and

dependency exemptions and by including in the base of the tax interest, dividends, and capital gains income. The Michigan approach to local income taxation holds some useful lessons for States that find it necessary to sanction local taxation of income.

Recommendation No. 7. The Commission recommends taxation of personal income at the State rather than the local level, but if local income taxes are also levied, they should be authorized only in the form of a supplement ("piggyback") to be administered with the State tax.

States electing to relinquish the personal income tax to their local governments are urged (a) to limit them to as large taxing areas as possible, ideally coinciding with the boundaries of trading and economic areas, (b) to prescribe rules governing taxpayers, tax base, rates, etc., uniformly applicable to all local taxing jurisdictions, and (c) to provide technical assistance in the administering and enforcement of local income taxes.[12]

[12] Representative Crank dissents in part from this recommendation and states that: "Personal income taxes should not be utilized below the State level. Their attempted use by local governments promotes interlocal economic competition and results in unequal taxation of individuals with comparable income derived within and partly without the jurisdiction in which they reside."
Governor Dempsey abstains from this recommendation.

TAX CREDITS AND INTERGOVERNMENTAL FISCAL RELATIONS*

BY JAMES A. MAXWELL

CONCLUSION

> Everyone seems to want a degree of centralization, in those activities which are objects of his special interest, far larger than a wise economy of centralizing devices could possibly grant. Henry C. Simons, *Personal Income Taxation.***

Over the decades the philosophy of most Americans has been that public programs should be executed by State and local governments if possible, by the Federal Government if necessary. Recently the disturbed state of the world, together with increasing citizen awareness of pressing public needs, may have weakened the force of this conviction. The merits of federalism have been downgraded; those of centralized government have been elevated.

And yet the belief is reasonable that, short of war, growth in the complexity and the scope of governmental duties should enhance the merits of federalism. Some governmental decisions must be made at the Federal level, but there are many governmental services affecting the diverse daily life of the people about which uniform regulation and administration from a central source would be mischievous as well as impracticable. Centralized decision would be irresponsive to the variety of State and local needs.

The case for federalism—for decentralized decision and administration—rests on more than an appeal to efficiency. This is a dynamic Nation; the appropriate way to handle governmental functions does not stay put. In such circumstances, State and local governments provide limited laboratories for experimentation in administration. Even more important is the fact that the State and local governments are bulwarks of democracy. Only where the people of a nation have adequate powers of decision can they develop a public spirit, and the specific knowledge and techniques that give life to free institutions.

A strong belief in federalism should not, however, be regarded as synonymous with an extreme belief in "States rights." States rights can be defined so as to have genuine meaning, but this meaning should not be twisted to block adjustments in the relative responsibilities of Federal Government and State-local government. In the modern world

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*Reprinted from Maxwell, James A.: *Tax Credits and Intergovernmental Fiscal Relations*, The Brookings Institution, Washington, D.C., August 1962, Chapter 7.

** Simons, *Personal Income Taxation* (University of Chicago Press, 1938), p. 215.

changes must be made, and rigid resistance to change can be injurious to the success of federalism.

In the preceding chapters some of the financial devices of cooperative federalism have been analyzed. Cooperative federalism discards separation of governmental functions and of sources of revenue as irrelevant in the modern United States. Morton Grodzins has argued that, even historically, separation never existed; it was always an irrelevant theory.

> The American Federal system has never been a system of separated governmental activities. * * * It is a misjudgment of our history and our present situation to believe that a neat separation of governmental functions could take place without drastic alterations in our society and system of government.[1]

Even if this historical deduction is disputed, the contention is convincing that now, and in the foreseeable future, cooperative federalism must be our trust. The Federal Government has, therefore, an essential role to play in helping to finance and coordinate State and local activities.

To accomplish its aims the Federal Government has available a variety of devices, and it has a modicum of experience with most of them. The device given most intensive analysis in these pages is the tax credit. Experience in its use is, perhaps, more instructive negatively than positively; mistakes to be avoided are more visible than are guidelines to be followed.

Experience With Tax Credits

The first Federal tax credit—that against the Federal estate tax for State death tax payments—was aimed inexactly at several objectives, none of them sharply defined and some of them in conflict. The Federal Government wished to yield a larger slice of death tax revenue to the States, and also to secure some measure of tax coordination. An 80-percent credit, provided in 1926, did decrease the Federal revenues and enable the States to increase their revenues if they picked up the allowable credits. But a sharp rise from $50,000 to $100,000 in the specific exemption of the Federal tax meant that many small estates or inheritances which paid a State tax were excluded from the credit. Moreover, Congress attached as a condition to the credit only that a State death tax be levied. The push toward uniformity was, therefore, merely the inducement to each State government to maximize the value of the credit for its taxpayers.

After 1932 the force of even this modest persuasion was impaired when Congress froze the 1926 credit and, at the same time, enacted a supplementary estate tax to increase Federal revenues. The relative value of aggregate credits in relation to aggregate Federal estate tax liabilities declined from 76 percent in 1931 to 10 percent in 1959. The States, under decreasing pressure to accomplish uniformity and under growing pressure to secure more revenue, enacted death taxes which varied in type, definitions, rates, and exemptions, so that complexity and structural disorder became serious problems.

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[1] Grodzins, "The Federal System," in *Goals for Americans:* Report of the President's Commission on National Goals (Prentice-Hall, 1960, for the American Assembly), pp. 268, 271.

In 1961 the new Advisory Commission on Intergovernmental Relations proposed revision and increase of the credit in an effort to achieve tax coordination and to provide State governments with additional revenue. Two conditions would be attached to the credit: (1) a shift to estate taxes and (2) revenue maintenance, i.e., that each State raise the annual level of its death tax revenue by an amount equal to the increase in the tax credits secured on Federal returns filed from the State.

The second tax credit for which there is experience is that against the Federal unemployment insurance tax, enacted in 1935. While the death tax credit was devoid of conditions, this one carried a substantial set of Federal requirements. Beyond doubt the credit with its conditions secured prompt creation of a system of unemployment insurance over the Nation, and this system, at the outset, had considerable uniformity in its major provisions. But in the years since 1935 unforeseen developments have impaired the equity and efficiency of the system. Instead of a uniform rate of payroll tax, a variety of rates prevails, and the average rate differs greatly from State to State. The danger of interstate competition, which had held back State provision of unemployment insurance before 1935, has reappeared. Other flaws in the present Federal-State scheme have led some to believe that it should be replaced by a purely Federal scheme. However this may be, the tax credit, in this its most ambitious use, has proved inflexible. Possibly, even probably, the credit was not the right technique to secure a good system of national unemployment insurance for the long run.

The experience sketched above indicates that in the case of the death tax the Federal Government failed to impose enough conditions to secure national objectives, while in the case of the unemployment insurance tax it imposed conditions which erred in the opposite direction. How achieve the right combination? The essential characteristics of the conditions of a credit should be simplicity and flexibility; simplicity in order to avoid detailed and extensive Federal supervision; flexibility so that, as Federal objectives alter over time, the conditions may be modified.

Proposals for Income Tax Credits

Proposals have recently been advanced that credits against Federal individual income tax liability be allowed for State income tax payments. Such a scheme would discriminate against residents of the States without income tax, of which there are presently 18. While this discrimination would be removed if these States enacted income taxes, the enactment would stem from Federal coercion. One proposal—that of Walter W. Heller—was examined in chapter 4. A regressively graduated credit is suggested, so that a larger percentage credit would be received for a small than for a large tax liability. Beyond a doubt crediting of this sort has a potential which might promote two broad national objectives: (1) helping State governments to finance their functions, (2) securing tax coordination.

If emphasis is given by Congress to coordination, individuals would be allowed to credit certain State income tax payments against cer-

tain of their Federal payments, provided the form of the State tax met Federal conditions aimed at reducing conflict. States with a creditable tax already in operation could allow their residents to use the credit simply to reduce their Federal taxes; these States would not, in this case, secure any additional revenue.

If, on the other hand, emphasis is given to use of the credit to provide all States with additional financial resources, individuals in a State would be allowed credits provided that State tax payments were increased *pari passu* as Federal payments were lowered. In this way crediting is coupled with a condition of revenue maintenance, so that total payments—Federal plus State—by individuals in a State are unchanged. Unless revenue maintenance is required, crediting is merely an indirect means of reducing Federal revenue. Its justification, in comparison with overt Federal tax reduction, would have to rest on the national advantage secured through tax coordination and use of the creditable tax—for example, the individual income tax—by a larger number of States.

REVENUE MAINTENANCE AS A CONDITION

If revenue maintenance is made a necessary condition of crediting, the question arises: How may the condition be met? Here the *form* of the credit is important. A regressively graduated credit will open relatively more sources of revenue to "poor" States than a credit expressed as a uniform percentage of Federal tax-liability. And such a credit opens to State governments the opportunity to raise this new revenue predominantly from low and middle incomes by enacting a scale of regressive rates in order to maximize the value of the credits. The objection that, thereby, the tax systems of State governments are made less progressive than otherwise is unconvincing.

State tax systems have always been regressive, or only modestly progressive, for the simple reason that State governments cannot successfully apply much progression in taxing large incomes or estates. Large incomes (estates) are mobile and almost always national in origin. Only with difficulty can they be equitably segmented for purposes of State taxation. Moreover, taxation of low and middle incomes provide State governments with relatively stable revenues. That a credit—specifically an income tax credit—does not add to overall progression or provide interstate equalization, as some proponents have supposed it would, seems a minor flaw.

A requirement of revenue maintenance does not preclude other conditions aimed at tax coordination. The Federal Government might make specifications concerning the acceptable State tax, and here the Advisory Commission on Intergovernmental Relations has provided a precedent by its recommendation that only estate-type death taxes be eligible for a new and enlarged death tax credit. An individual income tax credit, for example, might specify that the State define income so as to exclude income of nonresidents. Conditions of this sort, once accepted and put into operation, might well lead to a further step in centralization, namely complete Federal collection and administration of the tax in question, each of the States having the right to designate the rate supplements which it wished to be collected from its

residents. The Nation, in this case, would have eliminated the tax conflict and waste of resources which now occur through multiple administration and compliance costs.

In appendix B, table 1, estimates are offered of the maximum income tax credits which would, under certain assumptions, have accrued to the individual States in 1958. While the estimates are rough, a significant improvement in accuracy could be secured only by a more elaborate compilation of *Statistics of Income, 1958: Individual Income Tax Returns*, State by State. The estimates show that even the Heller-type credit would not be effective in strengthening the relative revenue sources of the poor States.

The potential merits of crediting as a device of tax coordination and financial aid should not obscure recognition of the dangers disclosed by the two instances of actual use, especially the danger of inflexibility. The States were pushed by the credits into patterns subject to change only by desuetude. In the case of the death tax credit, Congress reneged within 7 years on the objectives it espoused at the time the credit was provided; in the case of the unemployment insurance credit, Congress allowed its objectives to molder because of the difficulties of revision of the original scheme. Even if Congress has clear objectives when it provides a credit, these are bound to require redefinition over time, and provision for redefinition should be written into the original scheme. Indeed, an inherent and built-in defect of intergovernmental financial arrangements is their insusceptibility to easy modification. The reason is obvious—that they *are* intergovernmental.

Yet the defect can, perhaps, be abated, if not banished. Congress should indicate its objectives when it enacts a device, not by a vague preamble, but by a specific and precise declaration. Congress should assume the responsibility, through its committee structure, of securing annual reports on the operation of a device. Congress ought, probably, to set a timespan on a device, so that reenactment or termination will be necessary. It may be also that representatives of State and local governments should, somehow, be tied into the annual reporting and review through a body such as the Advisory Commission on Intergovernmental Relations.[2]

Credits as a Substitute for Deductibility

Crediting of State income taxes against the Federal tax has been suggested as a substitute for the long-established right of individuals to deduct payments of State and local personal taxes from adjusted gross income. The desire to abolish deductibility arises (1) because of its untidy rationale—indeed, the lack of any rationale for deductibility of benefit taxes; (2) because deductibility of certain other taxes, notably property taxes and excises, is discriminatory against classes of people, e.g., renters of residential property, and nonsmokers; and (3) because the higher the income of a taxpayer, the larger the reduction in Federal tax through deductibility.

[2] My own view is that Congress is responsive to the opinions of State and local governments when these secure expression through recognized and responsible channels. When Federal legislation has overlooked legitimate State and local interests, the reason has been congressional ignorance of what these interests are.

Some of these objections are unconvincing. Though the case is clear for abolition of deductibility of taxes which are, in effect, specific user charges, a similar step with respect to general taxes (on property, income, consumption) is not. The discrimination against renters of residential property, associated with deductibility of property taxes on owner-occupied dwellings could be removed by taxing imputed rent as income; it is not an inherent fault of deductibility. The objection that deductibility is more valuable to people with high incomes than to those with low incomes assumes implicitly that the scale of progression of the Federal tax is determined without reference to the deductions allowed from income by Congress. The opposite assumption is more plausible: that Congress determines the rates only after adjusted gross income has been refined by substraction of deductible taxes. In a federalism the National Government should exercise discretion in utilizing sources of revenue, bearing in mind that State and local governments provide essential services, financed by taxes which reduce individual incomes. Tax deductions stand for *governmental* outlays which, as much as Federal expenditures, go for public purposes.

Some critics have exaggerated the advantages that deductibility brings to the rich States. They forget that aggregate State and local taxes are regressive. As a result, these taxes are advantageous as deductions to residents of States with regressive taxes. The critics forget also that deductibility now provides some indirect subsidy to local governments, while crediting, most probably, would subsidize only State governments. In appendix C, table 1, State-by-State estimates of the amounts of taxes eligible as deductions in 1957 are offered. The method used is to refine figures of State and local tax collections so as to secure figures of personal or nonbusiness taxes. Comparisons are made also of amounts of deductible taxes with taxes actually deducted. The quantitative results strengthen the belief that "poor" States would be losers from substitution even of the Heller-type credit for deductibility.

The case for the substitution of crediting for deductibility must rest on the proposition that crediting, as a new broom, would sweep away a few of the anachronistic advantages to the individual taxpayer which are now embedded in deductibility. More important, it would stimulate steps toward tax coordination and orderly intergovernmental finance and, if coupled with revenue-maintenance, provide all State governments with additional revenues. These advantages might, perhaps, be gained with less resistance, especially from States without income tax, if crediting against Federal income tax were permitted for payments of State general sales tax, as well as for payments of State income tax.

Other Devices: Grants and Tax Sharing

Tax credits, coupled with revenue-maintenance, are not geographically equalizing: they bring no interstate transfer of resources. Geographical equalization has never been an explicit Federal objective, although it has often been an incidental result. Indeed, both the Federal tax system and the Federal expenditure program are equalizing.

CONDITIONAL GRANTS

Of all Federal-State financial devices, conditional grants display what appear, at first sight, to be equalizing objectives, since the formulas for allocation of Federal money assign more to poor than to rich States. But here also equalization is an incidental result. The explicit and important congressional objective is to accelerate accomplishment of some specific program by the poor States. Moreover, even in these grant programs, the progressive Federal tax system which collects the amounts to be distributed as grants accomplishes more equalization than the grant formulas do.

When a grant program is specific—when it is for a defined activity—Congress has always provided for receipt of grants by all States, rich and poor. One reason is that "need" for a specific service is measured by absolute standards, and therefore all States, in this sense, will show "need." New York, a rich State, will have educational needs, even though its actual provision per pupil enrolled will greatly exceed average provision. Of course, if the grant program is designed to stimulate expenditure in *all* States, grants for *all* States are indicated. But if the aim is simply to insure provision of a foundation or minimum-level program in all States, then grants for all States are wasteful. Such grants should be limited to those States which cannot, by a reasonable effort, be expected to provide this level through their own finances.[3]

Specific or conditional grants by definition carry some Federal requirements in order that federal objectives be promoted. The requirements can be, and have been, tight or loose, broad or limited in range. If there is a national consensus concerning the objectives of a grant, Congress is likely to frame conditions with little trouble; if, however, national opinion is diverse, agreement over conditions will be hard to secure. A conditional grant program affects State-local decisions concerning expenditures, and Federal "interference" will be charged if established patterns are disturbed.

A tax credit with broad requirements is less likely to raise objection so long as the States are prepared to utilize the creditable tax. A credit gives no Federal direction concerning how the State revenues are to be used. Nonetheless, a credit may be a step toward centralization since, if the States conform a tax to federal specifications, complete Federal administration will seem to be a natural sequence with the States entitled to decide simply on the rate or rates which they wish to be levied as supplements to the Federal tax.

UNCONDITIONAL GRANTS

When a grant program is unconditional, the logical rationale for it is limited equalization; the formula should rest on the twin concepts of a standard effort and a minimum level of provision of a representative group of governmental services. Such an equalization formula is self-limiting and the program associated with it will be

[3] Stimulative programs may be economic and developmental in objective, or they may be welfare-oriented. In the latter case an equalization formula is indicated; in the former it is not. For example, in allocating Federal grants to the States for construction of interstate highways, the relevant criteria should be economic.

modest in scope, since "need" is measured relatively—by comparison with the actual provision of the services in all the States. The Federal objective is to enable the poor States to achieve this level by grants which bridge the gap between it and what they can provide by their own efforts. The most obvious objection to such a formula is that the self-limiting feature will be broken by "political" pressures. About this, the experience of two other federal countries is contradictory: in Australia the claimant ("poor") states, in receipt of equalizing grants, have not demanded or received "political" grants; in Canada the claimant provinces strive to be "equalized to the top," and the actual grant decisions have often been political.

TAX SHARING

Still another device is tax sharing, which would require complete Federal administration of a tax with the States entitled to a share of collections on some uniform basis. The device is, therefore, centralizing in its connotations; besides, agreement on a formula for sharing would be very difficult to secure. If the formula allocated the proceeds of, for example, individual income tax according to origin of the income or the domicile of the taxpayer, the richer States would get the lion's share. On the other hand, any basis of allocation resting on state need would break the linkage between the source of the income and the receipt of the distribution. Moreover, any plan for sharing would face a problem arising out of unequal present use of income tax by the States. Oregon in 1958 collected an amount equal to 28.7 percent of Federal collections in the State. If this performance were to set the standard for a scheme—and uniform sharing would seem necessary—the Federal Government would find the scheme expensive. Similar problems would arise in Federal collection-state sharing of any tax.

Philosophers have observed that life is richer than logic, and, by an obvious parallel, the armory of devices examined here defies simple and categorical appraisal. Intergovernmental financial cooperation can be advanced by many devices, and, so long as illogic is avoided in their construction, the devices should be appraised in the light of the objectives which the Congress has in mind. Tax credits, for instance, can be utilized to advance tax coordination and to provide financial resources for State governments, and only by misuse might they be framed so as to aggravate tax conflict or so as to be dissipated in tax reduction. But tax credits do not provide for equalization, and they tend to be inflexible. If equalization is to be emphasized, the appropriate device is the unconditional grant; if stimulus to specific governmental functions, the conditional grant. Since Federal objectives in assisting State and local governments are manifold, there is no inconsistency in logical use of several devices.

TAX COORDINATION*

BY GEORGE F. BREAK

A Federal fiscal system faces two kinds of tax coordination problems. The first arises when two or more different levels of government use the same tax base, as when the Federal Government and a State government tax the same income (vertical tax overlapping); the second appears when large businesses or mobile individuals carry out economic activities in many different taxing jurisdictions at the same level of government, such as different States (horizontal tax overlapping). Both kinds of overlapping are widespread in the United States today, and both are capable of creating economic inefficiencies and taxpayer inequities which, if allowed to develop, will seriously restrict the spending powers of State and local governments.

The undesirable effects take several forms. A badly designed State and local tax system will soon reach its limit in producing additional tax revenues. At this point, high-priority public needs may go unsatisfied either because few desirable kinds of new taxes are available or because voters cannot agree as to which new tax they find least onerous. In another case regressive taxes, for which State and local governments have shown a strong penchant in the past, may penalize low-income individuals by preventing them from attaining their full productive capacity. The result may be a significant undermining of the State and local economic base needed to support vital public programs. Finally, taxes that are difficult to administer tend to divert government expenditures from more important purposes. It is the task of tax coordination to avoid all of these undesirable developments.

The general background for the discussion can be quickly sketched. Those conditions that make for a large amount of horizontal tax overlapping—businesses operating in many States and taxpayers living in one community and working in another—have long been familiar characteristics of the American economy. Nor is vertical tax overlapping likely to be unfamiliar to the average taxpayer except, perhaps, by name. At the beginning of 1964 individual income taxes were collected by 36 states and a large number of local governments, mainly in Ohio and Pennsylvania. Death taxation was shared by the Federal Government and 49 States, and excises on gasoline, tobacco, liquor, and amusements were used in varying degrees by all three levels of government.

In spite of these multiple usages, which have increased over time, the major tax sources have remained highly concentrated in the hands of one level of government. As table II–1 shows, almost all property tax receipts flowed into the hands of local governments in 1963–64:

*Reprinted from Break, George F., *Intergovernmental Fiscal Relations in the United States*, The Brookings Institution, Washington, January 1967, Chapter II.

93 percent of income tax revenues went to the Federal Government; and the States collected the dominant share of motor vehicle, general sales, and motor fuel taxes. These, of course, are national patterns which conceal the great diversities which exist among States and local areas. Complex as the picture may be, there is no doubt that vertical tax overlapping is important enough to warrant serious consideration.

TABLE II–1. *Federal, State, and local tax collections, by major type of tax, 1963–64*

Tax	Percentage distribution [1]			Total yield (billions)
	Federal	State	Local	
Customs duties	100	0	0	$1.3
Property	0	3	97	21.2
Corporation income	93	7	(2)	25.2
Individual income	93	6	1	52.5
Motor vehicle and operators' license fees	0	94	6	2.0
General sales and gross receipts	0	84	16	7.3
Alcoholic beverage excises	80	20	1	4.4
Tobacco excises	62	36	2	3.3
Motor fuel excises	40	60	1	6.8
Public utility excises	54	27	19	1.9
Other excises	75	22	2	5.7
Death and gift	78	22	(3)	3.1
All other taxes	31	50	19	3.7

Source: Computed from data given in U.S. Bureau of the Census, Governmental Finances in 1963–64 (1965), p. 22.
[1] Percentages are rounded and may not add to 100.
[2] Minor amount included in individual income tax figure.
[3] Minor amount included in "all other taxes."

SEPARATION OF TAX SOURCES

The most obvious solution to vertical overlapping would be to divide the major tax sources among the different levels of government, granting each of them exclusive jurisdiction over its own type of tax. Suppose, for example, that tax collections in a given year were as follows:

	Federal	State
Tax A	80	10
Tax B	10	50

Under these circumstances, would it not be more efficient for the Federal Government to relinquish its share of Tax B in return for State abandonment of tax A? With revenue maintenance, the tax structure would then be:

	Federal	State
Tax A	90	
Tax B		60

There are two basic difficulties in this solution. The first is that tax B might be such that it could not be effectively administered by the States acting alone. If so, the move would be precluded on grounds of efficiency. The second difficulty is that the shift might interfere unduly with the States' freedom to design their own tax structures.

It would be one thing if all States used both taxes A and B and were more or less indifferent to small changes in their relative importance, but quite another if some States used A but not B and strongly preferred that pattern to the alternative. Finally, though the plan involves no change in national tax revenues, it is almost certain to have diverse effects among the States. The States that experience a net increase in Federal tax burdens can be expected to be less than enchanted with the reform.

It may be thought that we have biased the case against tax separation by choosing an example in which vertical tax overlapping already existed. Suppose, then, that tax A is used only by the Federal Government and B is used exclusively by the State governments. Then suppose that State governments find themselves in need of additional revenue. Under these conditions, additional administrative and compliance costs will have to be incurred at the State level and they may well be less (or at least not significantly more) with tax A than with its principal competitors. If, in addition, tax A is judged high on equity grounds and is relatively free of undesirable economic effects, the choice should go to it, even though its adoption increases the amount of vertical overlapping in the tax system.

In view of these drawbacks it is not surprising to find that tax separation has so far had only limited success in this country. Property taxes, it is true, have been increasingly reserved for local governments, but the Federal Government has not been highly successful in shifting either spending programs or revenue sources to State and local governments. A concerted effort to do both, by the Eisenhower administration's Joint Federal-State Action Committee in 1957–59, produced only the modest proposal that the States take over full responsibility for vocational education and the construction of waste treatment plants (then being supported by a Federal grant of some $80 million a year) in return for a tax credit against part of the Federal excise on local telephone service. Though the plan was carefully designed so that no State would have lost money from the shift, at least in the short run, Congressional approval was not forthcoming. During the 1950's the Federal Government also repealed its tax on electrical energy and substantially reduced its excises on admissions. Both levies are generally regarded as well as suited for use by State and local governments, but in neither case was much of the slack taken up.[1] Nor is it likely that the Federal excises eliminated in 1965 will reappear to any large degree in State-local tax systems. The resulting reduction in Federal tax burdens may, of course, stimulate some increases in other kinds of State and local taxes, but it remains to be seen how important these will be.

Complete tax separation, it would appear, is neither attainable nor desirable. Too many of the taxes usually listed as suitable for exclusive State and local use[2] are inequitable or inefficient or both, and

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[1] L. M. Labovitz and L. L. Ecker-Racz, "Practical Solutions to Financial Problems Created by the Multilevel Political Structure," in National Bureau of Economic Research, *Public Finances: Needs, Sources and Utilization* (Princeton University Press, 1961), p. 172.

[2] The list includes general sales taxes, death and gift taxes, and excises on amusements, cigarettes, club dues, coin-operated machines, gasoline, motor vehicle registration, local telephone service, and safe deposit boxes. See Douglas H. Eldridge, "Equity, Administration and Compliance, and Intergovernmental Fiscal Aspects," in *The Role of Direct and Indirect Taxes in the Federal Revenue System*. A Conference Report of the National Bureau of Economic Research and the Brookings Institution (Princeton University Press, 1964), p. 191.

some of the most important ones seem firmly entrenched at the Federal level. Limited gains in this area will probably continue to be made, but most of the problems of tax coordination will need to be solved by other means.

Coordinated Tax Administration

One means of coordinating taxes that has the attractive feature of allowing each government considerable freedom in designing and levying its own taxes is cooperative or joint tax administration. In the income tax field, Federal-State cooperation began as early as 1931, but for a long time its accomplishments were limited, partly for lack of appropriate economic incentives.[3] State officials could, and did, examine Federal tax returns with profit to their governments, but in the process they imposed costs on the Internal Revenue Service (IRS) for which it was not reimbursed (State payments for audit abstracts and photostatic copies accrued to the Treasury's General Fund). As a result, the IRS did not seek to expand the cooperative arrangements. Again, in 1949, when a plan was developed for the coordinated use of Federal-State income tax audits, it was found that the States had little *quid* to offer for the Federal *quo.*

The real breakthrough came in 1957, when the first of a new series of "agreements on the coordination of tax administration" was signed with Minnesota. These agreements (35 had been signed by early 1965) are distinguished by their breadth of scope and flexibility of terms. Exchange of information is not confined to income taxes, and the States have found that they can supply the IRS with a wide variety of useful data from their administrative files. This agreement forms a basis for Federal-State coordinated tax administration on a mutually beneficial basis. In 1960, for example, the IRS reported receipts of $10.6 million and costs of only $50,000 from the agreements. States can expect to gain in several ways. The direct revenue gains should be substantial—in 1959 California reported a net income of over $4 million from its use of Federal audit adjustments and its comparisons of Federal and State income tax returns.[4] Moreover, there are prospects of improved taxpayer compliance with the law and the likelihood that, with Federal technical assistance, the quality of State auditing will be greatly improved. Finally, it should be possible, particularly if Federal and State income tax laws are made as nearly alike as possible, to set up joint audit procedures, with savings to both governments.

Coordinated tax administration need not be confined to Federal-State fiscal relations. States can help their local governments deal with both property and nonproperty taxes; counties can assist smaller jurisdictions within their boundaries; and several adjoining units can cooperate to set up a more efficient, pooled administration of their common taxes. All of these means of increasing State-local spending powers were included in the 1966 State Legislative Program of the Advisory Commission on Intergovernmental Relations (ACIR).[5]

[3] Advisory Commission on Intergovernmental Relations (hereafter cited as ACIR), *Intergovernmental Cooperation in Tax Administration* (June 1961), pp. 2–7.
[4] Federation of Tax Administrators, *Federal-State Exchange of Tax Information* (1962), pp. 15, 19.
[5] ACIR, *1966 State Legislative Program* (October 1965), pp. 45–57.

COORDINATED TAX BASES

The use of similar, or even identical, income tax bases by Federal, State, and local governments would not only facilitate joint tax administration but also reduce the time and money spent by taxpayers in meeting their fiscal obligations. In recent years the Federal definition of adjusted gross income, or net income, or taxable income has been increasingly adopted as the basic figure from which the State income tax base is to be derived by a limited number of additions and subtractions.[6] If these involve only such simple alterations as the addition of interest income from State and local bonds and the subtraction of interest income from Federal bonds, the taxpayer is put to little additional trouble by the existence of a State income tax. Much more burdensome, however, are separate State rules for depreciation deductions, because in most cases these would require extensive alterations in the firm's accounting records.[7]

Close conformity to Federal income tax law is not without its costs. Whenever that law changes significantly, State income tax authorities either have to incorporate those changes in their own law, or if their law is set up so as to conform automatically to the Federal tax base, they must decide which of the changes they wish to keep out of their own law. For example, New York State found that during the first few years of its new automatically conforming State income tax, approved by its voters in November 1959, it was necessary to pass more than 30 laws providing for differences between the Federal tax base and its own.[8]

A second potential problem is that it may be more difficult for state authorities to predict the revenues that will be yielded by a coordinated tax system than by an independent, and more structurally stable, state income tax. Should this be so, an evaluation of coordinated tax policy should taxe account of the extra costs of state revenue projections which must be credited against the administrative and compliance cost savings. Finally, state legislators may be reluctant to make state income taxes conform closely with the federal tax base for fear that statutory reductions will be made in the latter from time to time, thereby presenting them with the politically painful task of raising state tax rates in order to maintain revenues. How serious a problem this will be depends upon the future strength of the forces that have worked to erode the federal individual income tax base. Predictions of this sort are always hazardous, but Joseph A. Pechman, an astute

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[6] In 1964, 15 States were making use of the Federal individual income tax base in this way: Alaska, Colorado, Hawaii, Idaho, Indiana, Iowa, Kentucky, Minnesota, Montana, New Jersey, New Mexico, New York, North Dakota, Vermont, and West Virginia. Sixteen were using the Federal corporate income tax base. In addition, California achieves a considerable degree of conformity by having its own separate income tax law but keeping its provisions similar to, or identical with, the corresponding provisions of the Federal law. See ACIR, *Tax Overlapping in the United States, 1964*, pp. 121, 142, and *Federal-State Coordination of Personal Income Taxes* (October 1965), pp. 167*ff*.

[7] For two detailed comparisons of Federal and State definitions of individual and corporate taxable income see *Federal-State Coordination of Personal Income Taxes*, and *State Taxation of Interstate Commerce*, H. Rept. 1480, 88th Cong., second sess., vol. I, pp. 255–280.

[8] California Legislature, Assembly Interim Committee on Revenue and Taxation, *Conformity of State Personal Income Tax Laws to Federal Personal Income Tax Laws*, A Major Tax Study, pt. 3 (September 1964), p. 11.

observer, declared of the Revenue Act of 1964, "[It] can be said to have finally halted the erosion of the individual income tax base which had been characteristic of almost every major tax law enacted since 1913 and to have reversed it to a small extent." [9]

To a considerable degree, then, federal-state coordination of income tax bases imposes additional burdens on state legislators and removes them from state tax administrators and state taxpayers. Nevertheless, it seems clear that state legislators have become increasingly well-disposed toward tax base coordination; [10] and the experience with it gained by such pioneering states as Alaska, Montana, New Mexico, and New York, all of which have adopted federal taxable income on a prospective basis, should enable other to judge more realistically the benefits and costs resulting from specific moves toward greater conformity.[11]

Municipal income taxes, which provide one of the solutions to the metropolitan fiscal problems discussed in chapter V, can also be closely coordinated with the Federal or in income tax States, the State tax base. That such integration is still the exception rather than the rule in this country appears to be largely an historical accident. The first city income tax, that enacted by Philadelphia in 1938, had to be restricted, because of State legal requirements, to wages and salaries and to the profits of sole proprietors and partners; and subsequent municipal income taxes levied in Ohio, Kentucky, and Missouri were all patterned on the Philadelphia model.

In 1962, however, Detroit broke away from this tradition by assessing all of the income of its residents. The Detroit tax was closely tied to the Federal definition of adjusted gross income, and in mid-1964 this feature was made general throughout the State by a law requiring all city taxes to be based on the Uniform City Income Tax Ordinance specified in the legislation. Michigan municipal income taxes, therefore, should involve relatively few taxpayer compliance costs, and city officials should find it relatively easy to work out joint administrative procedures with the Internal Revenue Service. Whether the Michigan levies, or any other kind of local income tax, can be developed into productive revenue sources, however, is likely to depend upon how well intergovernmental competition for business and for wealthy taxpayers is controlled. Various ways of doing so are discussed in chapter V.

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[9] "Individual Income Tax Provisions of the Revenue Act of 1964," *Journal of Finance*, vol. 20 (May 1965), p. 259. The 1964 Act actually made a small reduction in taxable income as defined in the Internal Revenue Code (less than 4/10 percent for tax returns filed in 1962, *ibid.*, p. 258), but Pechman's conclusion rests on the argument that adoption of the minimum standard deduction represents not an erosion of the tax base but an increase in personal exemptions and that elimination of the dividend credit, which had no impact on taxable income, should be regarded as a strengthening of the Federal tax base. Both of these points seem well taken.

[10] The four States adopting individual income taxes since World War II—Alaska in 1949, New Jersey and West Virginia in 1961, and Indiana in 1963—all based their laws explicitly on the Federal IRC, and Wisconsin recently completed a major tax revision designed to achieve greater conformity. See ACIR, *Federal-State Coordination of Personal Income Taxes*, ch. 7. It should be noted that the New Jersey tax is a very restricted levy that applies only to New York residents who derive income from New Jersey sources.

[11] From its detailed study of the problem the California Assembly's Interim Committee on Revenue and Taxation concluded that there should be a presumption in favor of the adoption of some coordination method but that more information was needed about its likely impact on the ability of the State to predict and control its own income tax revenues. See their *Conformity of State Personal Income Tax Laws to Federal Personal Income Tax Laws*, p. 8.

TAX SUPPLEMENTS

The ultimate in coordinated tax bases is provided by tax supplements. This device, which is an improtant part of local finance in Scandinavian countries,[12] has several attractive features:

1. The enacting government, say at the local level, uses the tax base defined by some higher level of government (State or Federal), but applies its own rates to that base. The municipality, therefore, remains free to vary its tax receipts each year in accordance with its financial needs.
2. The local tax is collected by the higher level of government, along with its own tax, and the local proceeds are then returned to their source. Municipalities, therefore, need not have their own separate administrative staffs but will simply pay for the services provided to them by the collecting government.
3. Taxpayers fill out only one tax form, and in some cases they will probably be unaware that they are paying two different taxes.

Tax supplements have been most successfully used in this country to integrate State and local sales taxes. Pioneered by Mississippi in 1950, the arrangement is now (1964) generally available in six States—California, Illinois, Mississippi, New Mexico, Tennessee, and Utah. In California both counties and cities can attach a 1-percent supplement to the State tax base, but counties must allow a credit for whatever taxes are imposed by cities within their boundaries. Though this arrangement does not favor cities,[13] counties have some bargaining power because their refusal to enter the uniform State sales tax system precludes the cities' enjoying its administrative advantages. In 1963–64 all of the cities in populous Los Angeles, Orange, and San Diego Counties used the maximum rate of 1 percent, but more than 200 other cities in the State used lower rates.[14]

Similar jurisdictional problems would occur for local supplements to State individual income taxes, though it does not appear that their solution would involve significant administrative complexities. State taxpayers are ordinarily required to itemize their income by type and to report both their place of residence and their place of business. For those living in one municipality and working in another, therefore, it should be a simple matter for the State, in return for an appropriate fee from local governments, to allocate each person's income according to an agreed-upon formula, to apply to each portion the relevant local tax rates, and then to return the net proceeds to the appropriate governments. The problems involved in designing such allocation formulas are discussed later.

Another difficulty with income tax supplements is the lack of a rational and equitable base to which to attach them. There is no need at this point to discuss the well-known deficiencies of Federal tax

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[12] Harold M. Groves, "New Sources of Light on Intergovernmental Fiscal Relations," *National Tax Journal,* vol. 5 (September 1952), pp. 234–238, and Harvard Law School, International Program in Taxation, *Taxation in Sweden* (Little, Brown, 1959), pp. 519*ff.*

[13] In 1962–63, for example, California cities, though they had less than 70 percent of the population, received 84 percent of the total sales tax revenue returned to local jurisdictions. It should be stressed that both percentages exclude the combined city and county of San Francisco. See California Legislature, Assembly Interim Committee on Revenue and Taxation, *Financing Local Government in California,* A Major Tax Study, pt. 6 (December 1964), pp. 69–77.

[14] California State Board of Equalization, *Annual Report 1963–64,* pp. A–46—A–49.

law [15] (which, as noted earlier, has had an important influence on State statutes) or to speculate about the probabilities of their removal in the near future. In the meantime, most State and local governments will probably wish to continue to make their own alterations in the Federal definition of taxable income. Their task in doing so, however, is far from simple. Each departure from the Federal base must be evaluated by comparing the increased complexity it generates with the gains in interpersonal equity and in State economic performance it is likely to produce. Though recent technical studies of these matters do provide helpful guidance,[16] much research remains to be done. As it progresses, the Advisory Commission on Intergovernmental Relations might well make the results available to State and local officials in the form of periodic analyses of specific issues concerning intergovernmental conformity in the definition of taxable income.[17]

The highest degree of Federal-State income tax coordination, attained by Alaska between 1949 and 1964 and by West Virginia between 1961 and 1964, is achieved by making each person's State tax a flat percentage of his Federal income tax liability. Though this is a simple way of incorporating Federal tax rate progression into State law, it has the disadvantage of making State income tax revenues highly sensitive to Federal tax policy. While the Revenue Act of 1964, for example, maintained the Federal tax base virtually unchanged, it reduced Federal tax liabilities in that year by nearly $10 billion,[18] thereby creating serious revenue deficiencies in Alaska and West Virginia and helping to induce their shift to conformity on the basis of Federal taxable income, rather than Federal tax liabilities.

In summary, then, tax supplements appear to be a promising coordination device whose chief use so far in this country has been to integrate State and local sales taxes. Similar linkages between State and individual income taxes also seem feasible, and may stimulate further diversification of property-dominated local tax systems. Though constitutional and other impediments make supplements to the Federal income tax less likely, virtually the same effects can be achieved by the use of the various means of coordinating tax bases discussed in the preceding section.

TAX DEDUCTIONS

The distinguishing characteristic of the coordinating devices so far considered is the great freedom they give each level of government to act independently. The freedom to act, however, is also the freedom to miss important opportunities. If intergovernmental competition is, as many believe, a major constraint on the taxing powers of some State and local governments (see ch. I), their citizens, if given the choice, might well prefer a little less fiscal freedom and a few more

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[15] See, on this point, Richard Goode, *The Individual Income Tax* (Brookings Institution, 1964). Joseph A. Pechman, "Erosion of the Individual Income Tax," *National Tax Journal*, vol. 10 (March 1957), pp. 1–25, and the papers by Pechman and William F. Hellmuth in U.S. Congress, House Committee on Ways and Means, *Tax Revision Compendium*, vol. I (1959), pp. 251–316.

[16] See, for example, Richard Goode, *op. cit.*, and the already cited California Assembly's *Conformity of State Personal Income Tax Laws to Federal Personal Income Tax Laws*.

[17] A modest beginning has already been made in its publication on *Federal-State Coordination of Personal Income Taxes*, ch. 7.

[18] This was 19 percent of the 1964 liabilities that would have been incurred under the 1954 Code. See Pechman in *Journal of Finance, op. cit.*, p. 259.

high-priority public services. Three different ways in which the Federal Government can help in this regard, all involving tax coordination, are discussed in this and the following two sections.

By allowing the deduction of State and local income, property, gasoline, and general sales taxes under its own individual income tax, the Federal Government mitigates the impact on taxpayers of any increases in those four taxes, and thereby presumably strengthens the fiscal powers of State and local governments. The loss of freedom in this case is all at the Federal level—in effect, the Treasury agrees to pay part of any State or local tax increases in the four selected areas. Professional evaluations of this situation differ widely,[19] but in general one can say that the deductibility of gasoline taxes has the least support and the deductibility of income taxes the most.

The important question here is to what extent deductibility reduces opposition to State and local tax increases, either from taxpayers resisting additional tax burdens or legislators fearful of a loss of business to lower-tax areas. Although there is little or no concrete evidence in this area, three propositions and the policy guidelines they provide are worth considering.

The first proposition is that, other things being equal, taxpayers oppose benefit levies, such as gasoline taxes earmarked for highways, less than other kinds of taxes; Federal deductibility, therefore is less important for benefit taxes. The argument here is that taxpayers see in ordinary tax rate increases only, or mainly, the additional burden to themselves. The more informed among them. however, will recognize the mitigating effects of Federal deductibility. For benefit levies, on the other hand, the taxpayer and voter considers mainly the value of government services financed by the tax. Federal deductibility is a minor part of the whole picture.

The second proposition is that awareness of, and sensitivity to, Federal provisions for deducting State and local taxes is greater among high-income than among low-income taxpayers. This should be true not only because the tax value of deductions increase with income but also because high-income taxpayers typically itemize their deductions, whereas low-income taxpayers typically do not.[20] In addition, tax consciousness in general probably increases with income level. A recent study of this question for high-income taxpayers in this country found that whereas 35 percent of the total income of the subgroup with adjusted gross incomes between $10,000 and $30,000 was received by those who were aware of their marginal tax rates, only 15 percent of the income of those receiving over $30,000 went to people who were unaware of their marginal rates.[21]

The third proposition is that uncertainty as to the burdens to be imposed by a given tax increase tends to blunt both opposition to the tax

[19] Compare, for example, the papers by Harvey Brazer and Walter W. Heller in *Tax Revision Compendium,* vol. I, pp. 407–418 and 419–433; Goode, *op. cit.,* p. 178; James A. Maxwell, *Tax Credits and Intergovernmental Fiscal Relations,* (Brookings Institution, 1962), p. 105; and William Vickrey, *Agenda for Progressive Taxation* (Ronald, 1947), pp. 93–100.

[20] In 1960, for example, 75 percent of taxpayers with adjusted gross incomes between $2,000 and $3,000 took the standard deduction, but the percentage dropped to 29 percent between $10,000 and $25,000 and to well below 10 percent above $25,000. See Goode, *op. cit.,* p. 182.

[21] Bruce L. Gensemer, Jane A. Lean, and William B. Neenan, "Awareness of Marginal Income Tax Rates Among High-Income Taxpayers," *National Tax Journal,* vol. 18 (September 1965), p. 263.

change and the offsetting effects of Federal tax deductibility. Indirect taxes have long been felt to possess superior political appeal for this reason, though deductibility itself may well increase taxpayer awareness of sales and gasoline taxes, particularly if more and more people continue to itemize their deductions under the Federal tax.[22] Even so, changes in an individual income tax that is withheld at the source are likely to make more of an impression on the average taxpayer than equal changes in a general sales tax that excludes food, rentals, and many consumer services from its base.

Taken together, these three propositions throw doubts on the revenue-stimulating powers of all existing Federal deductibility rules except the ones applying to State and local income taxes. Not only is the gasoline tax a benefit levy, but both gasoline and general sales taxes impose burdens that are difficult to estimate quantitatively and their significance in relation to adjusted gross income is not high for families above $10,000. The following tabulation shows the relation of personal deductions for selected types of State and local taxes to adjusted gross income on taxable individual income tax returns with itemized deductions in 1960: [23]

Percent of adjusted gross income

Class	Real estate taxes	Sales taxes	State income taxes	Gasoline and other taxes
Under $2,000	2.1	1.5	0.3	2.6
$2,000 to $3,000	2.1	1.3	.3	2.2
$3,000 to $5,000	2.1	1.2	.4	2.0
$5,000 to $10,000	2.4	1.2	.6	1.6
$10,000 to $25,000	2.3	1.0	1.2	1.1
$25,000 to $50,000	1.7	.6	2.5	.7
$50,000 to $100,000	1.3	.4	3.0	.7
$100,000 to $500,000	1.1	.2	3.6	.8
$500,000 and over	.6	.1	3.3	.7

Property taxes, in contrast, are highly visible to homeowners, and their amounts are seldom insignificant. Moreover, they have many of the features of a benefits-received levy especially for families with children in the public schools. As a result, Federal deductibility for property taxes may well do little to strengthen the taxing powers of residential suburbs, especially those populated mainly by young families. The sole survivors of the three tests of effectiveness are deductions for State and local income taxes. Even they, however, may fall short of what is needed. Interstate and interlocal tax differentials are reduced but not eliminated by them, and they have so far failed to induce some of the most prosperous and industrialized States (Connecticut, Illinois, Michigan, New Jersey, Ohio, and Pennsylvania) to enact their own income taxes.[24] As a result, over one-third of the U.S. population is still free of State income taxation from its home States. For many observers who regard this as unfortunate the tax credit represents a promising reform measure.

[22] Between 1944 and 1960 the proportion of taxpayers doing so rose from under one-fifth to nearly one-half. Goode, *op. cit.*, p. 181.
[23] Goode, *op. cit.*, p. 177.
[24] Local income taxes do, however, flourish in three of these States. ACIR, *Tax Overlapping in the United States* (1964), pp. 134–138.

TAX CREDITS

Tax credits are a highly flexible fiscal device that can be used either to prevent excessive taxation of the same base by competing jurisdictions at the same level of government (to be discussed in a later section) or to strengthen the revenue bases of State and local governments. In their basic form, credits simply allow the deduction of one tax from another; but restrictions, which can be defined in terms of either of the two taxes involved, are frequently used to limit the amount of tax offsetting that can take place. The available formulas may be classified as follows:

1. *Proportional tax credits.* Here the taxpayer would be allowed to deduct x percent of his State tax against his Federal tax liability.
2. *Graduated tax credits.* These would divide state tax liabilities into brackets and allow the deduction of differing portions of each: for example, x percent of the first $100, y percent of the second $100, and z percent of the remainder. Regressive credits ($x>y>z$) include flat-sum allowances as a special case, and progressive credits ($x<y<z$) are similar in their distributional effects to tax deductions.
3. *Unlimited credits subject to a proportional ceiling.* Here the taxpayer would be allowed to deduct all of his State tax but only up to x percent of his total Federal tax liability.
4. *Unlimited credits subject to a graduated ceiling.* An example is the proposal made by Walter W. Heller in 1959 that State income taxes be made fully deductible from the Federal individual income tax up to 20 percent of the first $200 of liability, 10 percent of the next $300, and 1 percent of the remainder.[25]

There is no need at this point to discuss both the two existing Federal tax credits (those in the death tax and unemployment insurance fields) and the type most frequently urged for future adoption (a corporate and individual income tax credit). Since detailed analyses of the former are already available,[26] we shall use the latter to illustrate the principal strengths and weaknesses of tax credits in general.

Before a Federal income tax credit can be evaluated, its effects on State and local revenues must be predicted. The diversity of State attitudes to, and use of, income taxes is so great that this is no easy task. If the credit were of the unlimited variety (subject to a ceiling), it would clearly provide a strong, and probably irresistible, incentive to all States without income taxes to adopt them since they could do so, up to the amount of the ceiling, without cost to their own taxpayers. Some States, it is true, might hold back on the grounds that a progressive income tax is an iniquitous levy that ought not to be admitted to the state treasury and, if admitted, would inevitably grow beyond the limits of the Federal credit ceiling. The price of these fears, however, would be high, and even constitutional restrictions might crumble in the face of public pres-

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[25] *Op. cit.*, p. 425.
[26] Labovitz and Ecker-Racz, *op. cit.*, pp. 157–169; Maxwell, *op. cit.*, pp. 19–65; and ACIR, *Coordination of State and Federal Inheritance, Estate, and Gift Taxes* (January 1961).

sures on the legislature to enact a State income tax, at least designed to absorb the full Federal credit.[27] Maxwell estimated that in 1958 nearly half of a 7 percent Federal income tax credit would have accrued to the 19 States then lacking an individual income tax.[28]

At the other end of the spectrum would be the States already levying income taxes greater than the credit ceiling.[29] Their taxpayers would enjoy an immediate tax benefit, and it would be up to the States to divert part, or all, of these gains to themselves by raising tax rates. How successfully they would be able to do this, and what States taxes would be affected, is difficult to predict. These problems could be avoided by combining the tax credit with a revenue-maintenance requirement. In order to qualify States would then have to restructure their income taxes so as to raise their revenues from them by the full amount of the Federal credit.[30]

Such a credit, then, could bring important financial aid to State and local governments. Supporters also stress the opportunity it would provide for improving tax coordination by requiring, say, that eligible State income taxes be similar in structure to the Federal levy, that residents and nonresidents and multistate corporations be taxed in uniform ways, and so forth. These would be important gains, though they are probably attainable in other ways as well. Compared to straight Federal tax reduction, a proportional income tax credit would not only induce a greater increase in State and local revenues, but it would prabably also keep the Nation's tax system more progressive. The reason is that when States are left free to choose their own tax increases, they can be expected to expand sales and property taxes more than income taxes. Of course, opinions differ as to the desirability of this State policy. A tax credit would also complicate Federal policymaking, though not seriously. Future changes in the income tax would simply have to be evaluated in terms of their effects, through the credit, on State tax revenues and the credit then changed to achieve the results desired.

The most serious criticism of tax credits is that they are not well adapted to solving two of the most important fiscal problems of a federal system—unequal State and local fiscal capacities and the existence of State and local expenditure programs with significant spillover effects. Maxwell's calculations, for example, show that both proposals—a flat 7 percent ceiling credit and a graduated Heller-type credit—are positively correlated with State per capita incomes, through the Heller credits are somewhat more favorable to the poorer States.[31]

Unlike functional grants, tax credits leave the recipient free to spend the proceeds, as he wishes; therefore, they would probably be devoted to programs of local, rather than regional or national, interest. Nevertheless, adoption of a proportional Federal tax credit has

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[27] If the Federal credit ceiling were a flat x percent of Federal liabilities, such a "pick-up" tax would duplicate the Federal tax in every respect except that its bracket rates would be x percent of the Federal marginal rates.

[28] The amount was $1.1 billion out of a total credit of $2.4 billion. *Op. cit.*, p. 73.

[29] Eighteen such States in fiscal 1959 levied income taxes of $1.4 billion, compared to their maximum credit of $0.8 billion. *Ibid.*, p. 76.

[30] *Ibid.*, pp. 77–81.

[31] The correlation coefficients for 1958 were +0.865 for the 7 percent credit and +0.586 for the Heller credits. *Ibid.*, p. 89.

much appeal to those who believe that State use of individual income taxes has been unduly hampered by fears of interstate tax competition and by the heavy reliance placed on the tax by the Federal Government. A fractional credit, they argue, would help overcome these obstacles and would shift State tax systems toward greater equity and built-in sensitivity to economic growth. The Advisory Commission on Intergovernmental Relations, for example, recently recommended that Congress amend the Internal Revenue Code so as to give taxpayers the choice of continuing to itemize and to deduct their income tax payments to State and local governments or of claiming a "substantial percentage of such payments as a credit against their Federal income tax liability." [32]

CENTRALIZED TAX ADMINISTRATION

Though tax credits are frequently criticized for being unduly coercive, they actually leave receiving governments a great deal of fiscal freedom.[33] Strong-minded States may refuse to partake of a Federal credit—witness Nevada in the death tax field. Even those who do partake fully remain completely free to expand their revenues beyond the ceiling amounts subject to credit. That the Federal death tax credit has not set up an artificial barrier to tax increases is indicated by the fact that in recent years State death taxes have averaged 2.8 times the amount of the credit.[34] Such tax freedoms, however, are not without their costs. Duplicate tax administrations are necessary, and without close coordination they can be highly wasteful of resources or taxpayer equities. Worse still, if interstate competition is serious, the freedom to raise one's own tax rates may be an empty privilege indeed.

It is in situations of this sort that centralized tax administration has its greatest appeal. The tax in question is imposed and administered by only one level of government, say the Federal, and the net revenue or a portion of it is then returned to the various jurisdictions, say the States, from which it came. In essence, the States contract to have one of their taxes administered for them at that level of government where it can be done most efficiently.[35] At the same time, tax rates are made uniform throughout the country and the dangers of interstate tax competition are avoided. While the arrangement may be both productive and efficient, it does reduce the flexibility of State tax systems. To alter their receipts from the centrally administered tax. States must first agree among themselves as to what should be done and then have the desired changes made by the Federal Government.

An interesting proposal for centralized administration of cigarette taxes which involves both taxpayers and the Federal Government has recently been made by the Advisory Commission on Intergovernmen-

[32] *Federal-State Coordination of Personal Income Taxes* (October 1965), p. 19.

[33] This is not to deny that a very generous ceiling-type credit, applied to a Federal tax that had already been pushed to, or near, its revenue limit, would in effect freeze States into enjoyment of the revenues from that tax. Tax credits, however, need not be carried to such extremes.

[34] ACIR, *Coordination of State and Federal Inheritance, Estate, and Gift Taxes*, p. 49.

[35] Some writers refer to this arrangement as a type of tax sharing. However, centralized administration seems a more precise description, since the tax revenues are returned to their source, and the term "tax sharing" will be reserved for plans, to be discussed in ch. IV, which take the proceeds of some taxes and distribute them to State or local governments on a basis other than source.

tal Relations.[36] Imposed independently by the Federal Government and 49 States.[37] cigarette taxes yielded $3.2 billion in fiscal 1963, 63 percent going to the Federal Government, 36 percent to the States, and 1 percent to local jurisdictions. While the Federal tax is collected from the few manufacturers at a very low cost—less than one-thirtieth of 1 percent of the revenue yield—the State taxes are collected from a large number of jobbers, wholesalers, and retailers at an average cost of 5 percent of revenue.[38] Clearly, there should be much to gain from improved administration of State and local cigarette taxes.

After examining all of the standard coordination devices and finding them lacking, largely because of the wide diversity in cigarette tax rates among the States,[39] the Commission concluded that the most promising solution would be to dispense with the use of stamps and have each manufacturer add to his invoice the amount of tax imposed by the State to which the shipment was to go.[40] If both expert assistance from the Internal Revenue Service and cooperation from tobacco manufacturers were available, the States could save an estimated sum of at least $30 million a year by adopting the plan.

Centralized administration of existing State taxes is not likely unless the taxes are relatively uniform from one State to another. In its report on death tax coordination, for example, the Advisory Commission regarded such an arrangement as a desirable long-term objective, but they recognized that the States would first have to eliminate most of the many idiosyncrasies that now characterize their inheritance and estate taxes. To this end, the Commission recommended that any future liberalization of the Federal death tax credit be applied only to State taxes of the estate type, preferably modeled on the Federal law.[41]

Another set of taxes for which centralized administration is very attractive, at least in principle, are State and local levies on corporate profits. These taxes are characterized by important inefficiencies and inequities, but their conversion into a single, nationwide tax that is returned to the jurisdiction of source would involve two major difficulties. The first would be to define a practicable and equitable allocation formula. Net value added by corporate enterprises might be considered for this purpose, on the argument that income is created wherever the productive activity of the corporation takes place, but only rough estimates of its geographical distribution are currently available.[42] To serve as tax allocators these estimates would need to be refined and their computation placed on an annual, or some other

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[36] ACIR, *State-Federal Overlapping in Cigarette Taxes* (September 1964).

[37] Includes the District of Columbia. North Carolina and Oregon were the two nontaxing States.

[38] For an analysis of these costs see ACIR, *State-Federal Overlapping in Cigarette Taxes*, pp. 32–50.

[39] *Ibid.*, pp. 17–31.

[40] Reshipments out of that State would then be subject to tax adjustments made by the reshipper, under the supervision of State tax administrations. For further details see *ibid.*, pp. 53–62.

[41] ACIR, *Coordination of State and Federal Inheritance, Estate, and Gift Taxes*, pp. 10–24. Since States currently draw a significant amount of revenue from estates too small to be subject to Federal taxes, some broadening of the Federal base would presumably be necessary. Comprehensive reform of the Federal tax, designed to improve both horizontal and vertical equity, has long had wide support among tax experts. In the process, the revenue-producing powers of the Federal tax could be significantly increased and a large part of the gains returned to the States. Bowen's estimates for 1953, when Federal-State death taxes yielded only $1.1 billion, indicated potential yields ranging from $2 to $9 billion a year, and in recent years actual yields have exceeded $2.5 billion. See John C. Bowen, "Some Yield Estimates for Transfer Taxes," *National Tax Journal*, Vol. 12 (March 1959), pp. 54–68.

[42] For a brief discussion of some of the problems involved see ACID, *Measures of State and Local Fiscal Capacity and Tax Effort* (October 1962), pp. 23–25.

regular, basis.[43] Alternatively, a federally collected corporate income tax might be returned to the States whose residents actually bear the burdens of the levy. Here, of course, the problem would be to obtain a consensus on the extent to which corporate tax incidence falls on consumers, on workers, or on shareholders. Since economists are far from agreed on this question, whatever allocation formula was adopted would be a highly arbitrary one.

The second major problem would be to induce all corporate-income tax States to give up their own levies in return for an appropriate share of the Federal corporate tax. Exactly what portion of the latter would have to be distributed so that no State lost as a result of the interchange would, of course, depend upon the specific allocation formula that was chosen. Table II–2 shows the solution that would have resulted in 1959–61 from the use of a formula allocating 50 percent of the Federal corporate income tax to the States on the basis of retail sales and 50 percent on the basis of the dividends received by their residents, thereby allowing for an approximately equal split of the total incidence betwen consumers and shareholders. In the case of North Carolina a distribution of at least 15.4 percent of Federal tax collections would have been required to leave the State's fiscal position unaltered (neglecting whatever saving in administrative costs the State might enjoy as a result of the change). At the level of administrative budget receipts from corporate income taxes projected for fiscal 1966 ($27.6 billion), such a distribution would require a return of $4.25 billion to the States and would generate large windfall gains in the States shown in the first column of table II–2, to say nothing of the 13 that have no taxes at all on corporate income.

TABLE II–2.—*Corporation income taxes: State collections as a percentage of Federal collections,[1] averages for 1959–61*

	Percent
States under 5 percent (11):	
Alabama	4.7
Arizona	4.6
Delaware	4.0
Iowa	1.5
Kansas	4.4
Massachusetts [2]	4.1
Missouri	2.1
New Jersey	3.1
New Mexico [3]	3.2
North Dakota	3.3
Vermont	4.9
States 5 to 10 percent (16):	
Arkansas	9.3
Colorado	7.3
Connecticut	6.6
District of Columbia	6.4
Georgia	8.3
Idaho	9.9
Kentucky	9.4
Louisiana	7.8
Maryland	5.7
Montana	6.2
New York	8.9
Oklahoma	7.1
Rhode Island	7.7
Tennessee	8.2
Utah	8.0
Virginia	8.3
States 10 to 15 percent (9):	
Alaska	12.6
California	11.3
Hawaii	10.8
Minnesota	10.1
Mississippi	14.0
Oregon	12.3
Pennsylvania	10.0
South Carolina	14.2
Wisconsin	13.1
States 15 percent and over (1):	
North Carolina	15.4

[1] Allocated among the different States in the manner discussed in the text.
[2] State collections do not include corporation excise taxes and surtaxes measured in part by net income and in part by corporate excess, which are classified as licenses.
[3] Since State income tax collections include both the individual and the corporate tax, the computation is based on Federal and State collections from both taxes.

Source: ACIR, *Tax Overlapping in the United States*, 1964, p. 146.

[43] Unless reallocations were made at least as frequently as every 5 years, significant interstate discriminations would probably develop, because the centrally administered part of the Federal corporate income tax would tend to favor static and declining States at the expense of those growing more rapidly.

These last difficulties could be avoided if a completely new tax were added to the U.S. fiscal system at the Federal level, part of its proceeds being retained in Washington and part being returned to the States on the basis of some source-oriented allocation formula. Probably the most discussed candidate in recent years has been a Federal tax on the net value added by all business enterprises.[44] Whether such a levy has enough broad support to bring about its enactment in the near future is a moot question. Should that happen, however, the occasion would provide an excellent opportunity for a strengthening of State-local fiscal resources by means of centralized tax administration.[45]

Horizontal Tax Overlapping

In few areas of taxation does the gap between appearance and reality—between the laws as written and the taxes as administered—seem as broad as it is for the State taxation of interstate business income. An intensive, 3-year study of the problem, just completed by a special subcommittee of the House Committee on the Judiciary, concluded, among other things, that—

> In broad terms the demands of the States upon interstate businesses are largely disregarded. For the unusually scrupulous, the very naive, or the simply unlucky, the legal rules may describe the system; for the great mass of interstate companies, practice bears little relationship to the law * * * it is * * * a system in which the States are reaching farther and farther to impose smaller and smaller liabilities on more and more companies. It is * * * a system which calls upon tax administrators to enforce the unenforceable, and the taxpayer to comply with the uncompliable.[46]

Similar problems plague other taxes and complicate the fiscal interrelationships of local, as well as State, governments. Three aspects of the complex situation, selected for their importance and for the light they throw on other areas, are discussed briefly in the remainder of this section.

MOBILE TAXPAYERS

The metropolitan taxpayer who lives in one jurisdiction and works in another is a familiar figure in the modern world. How should the conflicting claims on his income from the government of residence and the government of employment be resolved? To answer, the economist refers to the "benefits received" theory of taxation, but it must be admitted that no precise solution can be obtained from it. There are, it is true, a number of government programs, such as water supply systems or public parks, that generate only private benefits which can be allocated more or less accurately to specific individuals. However, if services of this type are financed, as the benefits-received doctrine says they should be, by user charges, fees, and prices, they will

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[44] See, for example, House Committee on Ways and Means, *Excise Tax Compendium* (1964), pp. 89–107; Tax Institute of America, *Alternatives to Present Federal Taxes* (Princeton University Press, 1964); and Tax Foundation, Inc., *Federal Non-Income Taxes: an Examination of Selected Revenue Sources* (1965).

[45] Sharing of a Federal value-added tax would, of course, encounter the same difficulties in developing an allocation formula as were discussed above in connection with the Federal corporate profits tax.

[46] *State Taxation of Interstate Commerce*, H. Rept. 1480, by the Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, 88th Cong., second sess. (1964), vol. I, pp. 596, 598.

give rise to no allocation problems among local governments. Our concern, instead, is with the much larger group of public programs which produce major social benefits that cannot be allocated to specific persons. These are public services in the technical sense of the word, and we can say that their benefits accrue, as a whole, to each individual within the jurisdiction of the government that provides them. Satisfactory as this proposition may be for the person who never moves outside of a single jurisdiction, it is not very helpful in identifying the benefits enjoyed by a person who does move. These benefits are clearly some function of the benefits generated by the different governments with which he has some contact. But what is the form of that function?

One relevant consideration, presumably, is the amount of time that the income receiver and his family spend in each jurisdiction. On this basis, let me suggest a simple two-part rule for dividing his taxable income among competing governments:

1. Exclude all governments with which he has only minimal contact—for example, the place where he spends his vacation or where his wife does some of her shopping.
2. Allocate the right to tax his income among the remaining governments in rough proportion to the time spent working and living in each.

In practice, this rule should restrict consideration to two governmental units, those of residence and employment: of these two, the former should normally have the greater claim. Most city workers probably spend more time in their home suburbs than in the city, and this should be even more true for other members of their families.

A second relevant consideration is the structure of local government expeditures. Among these, education ranks supreme, and this fact, too, favors the claim of the government of residence. While public schools, as will be discussed in detail in chapter III, do create social benefits which accrue to the taxpayer both where he works and where he lives, the private benefits enjoyed by him and his family will normally be provided only by the government of residence. Finally, attention should be given to the interjurisdictional incidence and yield patterns of other local taxes. This means, for example, that the adoption of a local sales tax or the exclusion of business plant and equipment from the property tax may alter the basis on which local income taxes should be allocated among competing metropolitan governments. Specific solutions to this problem are discussed later in chapter V.

Similar jurisdiction problems apply to State individual income taxes, most of which allow a credit for income taxes paid to a nonresident State, some credit for taxes paid to a State of residence, some both, and some neither.[47] Not only do the credits for taxes paid to States of nonresidence frequently depend upon the nature of the reciprocity arrangements worked out with these States, but State definitions of "residence" often conflict with one another. As a result, mobile taxpayers can find their incomes subject to taxation in more than one State. Some consistent and uniform solution to these overlapping problems is clearly desirable. As already noted, it could be one of the valuable byproducts of enacting a Federal income tax credit.

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[47] ACIR, *Tax Overlapping in the United States, 1964*, p. 128.

INTERSTATE SALES

The inequitable over- or under-taxation of interstate sales is widely regarded as the most important problem created by State sales and use taxes. Two general principles of tax policy which assign interstate sales either to the State of destination or to the State of origin can be used in solving these problems, though neither is entirely satisfactory.

The destination principle rests squarely on the standard consumer-burden theory of sales tax incidence. According to this theory, prices will be higher in a sales-tax State (by the amount of the sales tax) than they will be in an income-tax State, the two States being similar in all other respects. From this it follows that the sales-tax State must exempt its exports to keep them from being at a competitive disadvantage in the income-tax State, and tax its imports to prevent them from entering at a competitive advantage over local products. To do this effectively, as the Fiscal and Financial (Neumark) Committee of the European Economic Community noted with regret,[48] requires fiscal frontiers at which all interstate shipments can be intercepted and controlled. Fortunately these frontiers are lacking in this country, so States have combined their sales taxes with use taxes. They have tried to collect use taxes either directly from consumers, with little success except for a few products, or indirectly from out-of-State vendors, also with limited success so far. Though the Supreme Court has helped [49] and serious attempts at enforcement have been made, a considerable amount of undertaxation presumably remains. At the same time, the failure of some States to allow credits for sales taxes paid elsewhere and the use by others of rules that discriminate against out-of-State sellers create some important instances of overtaxation.

Various solutions to these problems, all based on the destination principle, have been proposed. John F. Due, for example, has suggested the following five-point program for Federal action:

1. legislation requiring each State to allow a credit for sales taxes paid to the State of delivery, except for motor vehicles, which would be taxable only by the State of initial registration;
2. legislation regulating the interstate sales of one business firm to another so that the tax on them is payable by the purchaser to the State of destination whenever that firm is also registered there as a seller of taxable goods or services; [50]
3. legislation requiring out-of-state sellers to register and to pay sales tax to the State of destination whenever they have property or employees in that State, make regular deliveries of goods into it, or solicit business there either by the use of salesmen or agents or by the use of catalogs or direct-mail advertising;
4. legislation requiring any nonregistered out-of-State seller shipping goods from a sales-tax State to pay tax either to that State or to the State of designation; [51] and

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[43] Commerce Clearing House, Inc., *Tax Harmonization in the Common Market* (1963), pp. 78–83.

[49] Notably by sustaining the right of a State to require out-of-State vendors, with no permanent local establishment but with local independent sales representatives, to collect and remit State use taxes. *Scripto, Inc.* v. *Carson*, 362 U.S. 207 (1960).

[50] At present such sales may be taxable or not depending upon the use to which the purchaser puts the goods in question. To require the out-of-State seller to inquire into these matters in order to remit the correct amount of sales tax to the State of the purchaser clearly places excess burdens on the interstate seller.

[51] In the absence of such a mandatory option, the sales would presumably go untaxed: in its presence, the tax would probably go to the State of origin, because of the closer connection between the seller and that State, except where the State of destination had the lower tax rate.

5. legislation requiring any nonregistered out-of-State seller shipping goods from a non-sales-tax State either to pay the tax of the State of destination or to pay a tax based on a "model" sales tax law to the Federal Government which would then remit the net proceeds to the States of destination.[52] Another set of proposals, involving a somewhat more radical departure from existing practice, have recently been made by the House Judiciary (Willis) Subcommittee and are discussed in chapter VI.[53]

Under the origin principle a retail sales tax would be levied on all goods and services sold to final consumers by business operating within the taxing State, regardless of the location of those final consumers. In addition, there would be no use taxes, since imports would already have been taxed in the State of origin. Unless it were widely adopted on a uniform basis, such a system of sales taxation would encounter two major difficulties. The first would be the concern of businessmen operating in high-tax States about unfair competition from untaxed imports and about their own ability to export goods and services to low-tax regions.[54] The second problem would be the strong incentive provided to exporters who had been selling directly to out-of-State consumers to do so through intermediate distributors in a no-tax State, since this change would eliminate retail sales tax liabilities in their home State. Both of these problems become less and less important, however, as the use of an origin-oriented, single-stage sales tax is extended geographically. In the limit, if all States used the same tax rate, the problems would disappear, and there would be a uniform, nationwide retail sales tax which avoided the difficulties States now have in enforcing their use taxes.[55] In the absence of such a general tax—and that appears to be the prospect in this country for some time to come—the destination principle is likely to remain dominant, and further improvements in State sales and use taxes are likely to come, perhaps as a direct result of the projected 1966 Congressional hearings on the subject, from the reforms recommended by the House Judiciary Subcommittee, John Due, and other experts.

INTERSTATE BUSINESS INCOME

The multistate corporation has apparently been the source of a good many multistate tax headaches. In their efforts to tax its income, States have had great trouble answering two fundamental questions. When should a business be taxable in a given State; and if it is taxable, what

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[53] For further discussion of these proposals see John F. Due, "Sales Taxation and the Willis Subcommittee Report," *Illinois Business Review*, vol. 23 (January 1966), pp. 6–8. See also his "State Taxation of Interstate Commerce—Sales and Use Taxes," *Canadian Tax Journal* (November–December 1965), pp. 519–525.

[53] See pp. 236–238. For the analysis and recommendations of the Willis Subcommittee see *State Taxation of Interstate Commerce*, H. Rept. 565, 89th Cong., first sess., vol. 3 (June 30, 1965), pp. 603–895, and H. Rept. 952, 89th Cong., first sess., vol. 4 (Sept. 2, 1965), pp. 1136–1137 and 1177–1189, respectively.

[54] These producer worries stem, somewhat paradoxically, from the consumer-burden theory of sales tax incidence. If it could be shown that a State sales tax tended to raise retail prices no more than, say, an equal-yield State individual income tax, there would be no need for sales-tax-paying businessmen to worry about low-priced imports from income-tax States, and exporters from sales-tax States would tend to enjoy lower input prices than their competitors elsewhere. The extent to which State sales taxes push down factor prices rather than raise product prices, however, is a much debated question among the experts, and until the factor-burden theory of incidence achieves a broader acceptance than it now has, the difficulties mentioned in the text will probably persist.

[55] Enactment of such a tax system would presumably require Congressional action to remove any constitutional barriers imposed by the interstate commerce clause.

should be that State's fair share of the corporation's total interstate income?

The first question has to do with nexus, or State tax jurisdiction, about which—as the inquiries of the Special Subcommittee on State Taxation of Interstate Commerce amply demonstrated—there is little agreement among the States, either in practice or in principle.[56] At one end of the spectrum is the maintenance of a factory or retail store, which is universally considered sufficient to create taxability; in the middle is the maintenance of a stock of raw materials or of investment property, about which there is disagreement. Placed at the other end by explicit congressional action in Public Law 86–272 (73 Stat. 555 [1959]) is the mere solicitation of orders either by the corporation's own employees or by independent contractors—activities which do not create taxability as long as the orders are approved and filled from outside the State. Despite wide diversity among independently determined administrative practices, however, a broad consensus on a uniform nexus formula is not unobtainable, since many of the differences may be far from fundamental. To satisfy the usual canons of taxation, such a formula should be clear and definite, should entail administrative and compliance costs that are a low percentage of revenues produced, and should be legally enforceable by the States. In addition, it should be integrated with the division-of-income rules to be discussed below so that multistate business income is not assigned to States lacking effective power to tax it.[57]

Multistate business income can be divided up among the prospective claimants by separate accounting, by specific allocation, or by formula apportionment. Separate accounting involves the cracking apart of a single corporate enterprise for tax purposes and may be illustrated by a corporation that has two separate divisions, one in each of two States. If each buys its inputs and sells its output independently of the other, tax officials might be tempted to treat the two divisions as if they were separate enterprises, particularly if the officials belong to the State with the more profitable of the two divisions. Economists, however, object to this procedure because it ignores important economies of scale—in management, advertising, and fund raising—that the two divisions could not realize if they did operate separately. Nevertheless, State tax officials may find it difficult to view a diversified coporation stressing decentralized management in the same way as a corporation engaged in one integrated set of operations and may be willing, therefore, to incur some additional administrative costs in order to treat the two types differently.[58]

A second distinction that is frequently attempted is that between a multistate corporation's mainstream income, which cannot be claimed exclusively by any one State, and various kinds of subsidiary income, which can.[59] An example would be a headquarters building in New York City in which most of the space was rented out to other busi-

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[56] H. Rept. 1480, vol. I, pp. 141–152.

[57] *Ibid.*, pp. 485–516.

[58] For a discussion of the problems involved see Arthur B. Barber, "State Income Tax Uniformity Concerning Taxable Units," *National Tax Journal*, vol. 16 (December 1963), pp. 354–364; and George T. Altman and Frank M. Keesling, *Allocation of Income in State Taxation*, 2d ed. (Commerce Clearing House, Inc., 1950).

[59] In 1963 only six of the 38 income tax States did not provide for such specific income allocation. H. Rept. 1480, vol. I, p. 118.

nesses. New York (city or State or both) might then claim the sole right to tax that rental income.[60] This procedure, known as specific income allocation, involves the greatest difficulty when applied to intangible assets. Dividend and interest income, for example, has traditionally been allocated to the State of residence of the recipient, but claims to residence may be entered by both the State in which the business is incorporated and any State that views itself as the corporation's commercial domicile. Nor is it easy to measure net dividend or interest income since, in obtaining it, the corporation may incur costs that are difficult to segregate from its other expenses. One may seriously question whether the gains from specific income allocation are worth the costs involved.

The basic problem of dividing up multistate business income is encountered in the unitary, or mainstream, income of an integrated interstate corporation. It is generally agreed that this income must be apportioned by formula, but there is great controversy as to the components of that formula. Current practice for manufacturing corporations favors a three-factor formula based on property, payroll, and sales,[61] but many experts have been highly critical of including sales.[62] As the Special Subcommittee put it, "Of all the steps involved in the process of dividing income for tax purposes, the attribution of sales presents more problems than any other." [63]

The most popular procedure, which has become increasingly so in recent years, is to allocate sales on a destination basis, to the State of the consumer.[64] Unfortunately, this appears to be the most troublesome of all the available standards. The reason is that it greatly expands the number of companies that are, potentially at least, subject to income taxation in more than one State. In the Special Subcommittee's sample of interstate companies, for example, 66 percent of the manufacturing and 74 percent of the mercantile companies had places of business in only one State.[65] Under a rule that allocated sales by origin rather than destination (as well as under an income-apportionment formula based only on property and payroll), most of these companies would be taxable in one State only. The saving to them in compliance costs could be substantial.[66]

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[60] Other States, of course, might seek to combine the rental income with the corporation's other income which would be then apportioned by formula among all the States in which the corporation carried out business operations. For a detailed description of State practice in this area see *ibid.*, pp. 197–232, and for an analysis of the problem see Arthur B. Barber, " 'Nonapportionable Income' Under a Uniform State Net Income Tax Law Imposed by Congress," *National Tax Journal*, vol. 16 (June 1963), pp. 147–158.

[61] This formula was used in 1963 by 26 of the 38 States then taxing corporate net income. H. Rept. 1480, vol. I, p. 119.

[62] Arthur B. Barber, "A Suggested Shot at a Gordian Knot of Income Apportionment," *National Tax Journal*, vol. 13 (September 1960), pp. 243–251; Charles E. Ratliff, Jr., *Interstate Apportionment of Business Income for State Income Tax Purposes* (University of North Carolina Press, 1962); and Paul Studenski, "The Need for Federal Curbs on State Taxes on Interstate Commerce: An Economist's Viewpoint," 46 *Virginia Law Review* 1121 (1960).

[63] H. Rept. 1480, vol. I, p. 181.

[64] Such a market-oriented sales factor was used in 1963 by 24 States, compared to only 10 in 1955. The next most popular rule, which assigned sales according to the location of the office through which the sales transaction was made, was used by 18 States in 1955 and only 12 in 1963. *Ibid.*, p. 122.

[65] *Ibid.*, pp. 77–78.

[66] As would be expected, most of the one-State-place-of-business companies were small in size, and the special subcommittee's studies showed that income allocation by means of a sales factor was particularly burdensome to such companies. These compliance burdens would be substantially lessened, however, if sales below a certain minimum annual amount—the subcommittee used $100,000 in its studies—were allocated to the State of origin rather than of destination. *Ibid.*, pp. 508–513, 526.

A second criticism of the destination sales factor is that it allocates income to many States that lack sufficient nexus, or jurisdictional connection, to tax it. While in some cases a throwback rule is used to reallocate the income in question to the State of origin,[67] in others interstate corporations simply go undertaxed, compared to other companies with like amounts of income. Among 13 undertaxed multistate companies studied by the special subcommittee, two were taxed on less than half their incomes and the rest on percentages varying from 98½ to 52½.[68] Undertaxation, of course, is by no means a fortuitous phenomenon. States adopting a destination sales factor have frequently done so mainly to attract new business by offering it a "favorable tax climate." [69] It seems unlikely, therefore, that the States will give up these market oriented sales factors voluntarily. If they do not, corporate income taxation will remain an unreliable source of additional State and local revenue or a major overhaul of jurisdictional and apportionment rules will be necessary.

Some experts believe that such an overhaul would involve the complete elimination of the sales factor from income apportionment formulas. Logically, they argue, income should be apportioned according to the location of the land, labor, and capital goods that produce it. According to this test, sales would be entitled to consideration only to the extent that the company's own labor and propery were involved in the transactions; otherwise the value added in selling should be attributed to other businesses and their incomes taxed accordingly. To some, then, logic calls for a two-factor income apportionment formula based on tangible property and payrolls, and they also note that practical considerations reinforce their choice. Not only would nexus problems be greatly simplified, but administrative and compliance costs wolud be reduced as well.[70]

The problem, of course, is to persuade the nonindustrial States that a production-oriented apportionment formula would not unduly compromise their interests. To this end the special subcommittee undertook a detailed quantitative comparison of the revenue effects of the three leading types of formulas—property and payrolls only; property, payrolls, and a destination sales factor; and property, payrolls, and an origin sales factor. Their conclusion was that the revenue importance of the choice of formula is not great now and can be expected to become even less in the future. Nevertheless some States would lose,[71] and compromises would be needed to sell them the two-factor formula as a uniform income apportionment standard.

The logic behind the payroll-property formula, however, is not as unassailable as its supporters like to claim. The importance of demand is recognized only insofar as it is created by advertising and other selling activities on the part of business. If, in the spirit of Alfred

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[67] In 1963 10 of the States using a destination sales factor in their apportionment formulas had also a throwback rule, typically requiring that sales be assigned to the State of origin if the corporation was not taxable in the State of destination. *Ibid.*, p. 243.

[68] *Ibid.*, p. 395.

[69] *Ibid.*, pp. 122–127.

[70] *Ibid.*, pp. 521–563.

[71] The subcommittee's calculations showed that by shifting from their present tax laws to one of the subcommittee's three apportionment formulas 10 States would lose .05 percent or more of their total tax revenues. Four of them had above-average per capita personal income in 1963 (Alaska, District of Columbia, Massachusetts, and New York), three were close to the average (Colorado, Oregon, and Pennsylvania), and three were below average (Georgia, Iowa, and Montana). *Ibid.*, pp. 554–557.

Marshall's famous example involving the two blades of a pair of scissors,[72] aggregate demand and supply are equally important in the creation of value, sales surely deserve more attention than they receive in the two-factor formula.

The situation calls for a pragmatic solution that would pay considerable attention to existing practice and would sacrifice some elements of the ideal solution—whatever that may be—to obtain an early agreement by the States on uniform jurisdictional and income-allocation rules. The range of possibilities is, of course, large, but the following broad rules seem worthy of special consideration:

1. Make the right to tax corporate profits depend upon either some physical presence in the State—for example, property or payroll—or the completion of some above-minimum amount of sales there—perhaps $100,000 a year as suggested by the Judiciary Subcommittee.
2. Use a uniformly defined, three-factor, destination-sales apportionment formula.
3. Either exclude any sales made in States that lack taxing jurisdiction from the denominators of the income allocation formulas of other States or provide for the recapture of those sales by the States of origin.
4. Include all other sales in the income-apportionment formulas. Specifically, a State with below-minimum sales but with jurisdiction to tax because of the location in it of property or payroll would include those sales in the numerator of its apportionment formulas, and above-minimum sales made in nontaxing States would be included in the denominators of the formulas used by all taxing States.

Once uniform rules of this or some other sort have been adopted, it should be possible to promote greater efficiency by establishing some central agency to collect State profits taxes from all inter-State corporations, remit the proceeds—minus administrative costs—to the proper jurisdictions, and handle disputes between taxpayer and tax collector. The operations of such an agency would be greatly simplified if some uniform definition of taxable income were also adopted at the time it was established. The potential gains from such a solution to the taxing problems States now have with corporate income seem well worth the effort needed to develop the necessary uniform rules. Early action seems preferable to a lengthy and perhaps fruitless search for some ideal solution on which all could agree.

[72] "Thus again we see that demand and supply exert coordinate influences on wages; neither has a claim to predominance, any more than has either blade of a pair of scissors, or either pier of an arch." Alfred Marshall, *Principles of Economics*, 8th ed. (London: Macmillan, 1938), p. 532.

ALLOWANCES FOR STATE AND LOCAL NONBUSINESS TAXES*

BY BENJAMIN BRIDGES, JR.

POLICY CONCLUSIONS

The following policy conclusions may be drawn about equity and other aspects of the problem.

Improving tax equity. Large-scale broadening of the base of the Federal individual income tax is urgently needed in order to increase tax equity and to improve taxpayer morale. In this context it has been argued that the present treatment of deductibility of State-local nonbusiness taxes is quite inequitable. Various alternative proposals have been suggested for improving the equity of deductions currently permitted. Deductibility could be partially or completely removed. Alternatively, deductibility could be replaced by some form of Federal credit for State-local tax.

Given the recent sizable reductions in Federal statutory bracket rates, complete removal of deductibility of State-local nonbusiness taxes would be a desirable means of improving tax equity. Removal of deductibility would clearly achieve greater equity than would replacement of deductibility with a credit device. In the absence of substantial rate reduction, a first step could have been taken by limiting deductibility to State income taxes which exceed 3 percent of adjusted gross income. Such partial deductibility of State income taxes would have moderated interstate income tax differentials and prevented excessive combined marginal income tax rates for upper-income taxpayers.

Aiding State-local governments. Credits against the Federal individual income tax for State individual income taxes have been proposed as a method of providing Federal aid for State-local governments. Credits could either replace or supplement deductibility.

As a means of Federal aid the credit is more efficient per dollar of cost to the Federal Government than the present method which works through deductibility, but less efficient than direct Federal grants.

Substitution of such a credit for deductibility would cause a considerable increase in State-local tax collections (provided the maximum cost of the credit approximately equals the cost of deductibility). For plans 5 and 6, increases in State-local revenue would exceed $1,200 million for 1958. But for such a credit the resulting increase in State-local revenue would be considerably less than the revenue cost of the credit to the Federal Government. For Plans 5 and 6, increases in State-local revenue would probably be about two-thirds of the cost of the credit to the Federal Government. About one-third of the cost

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of the credit would be used to provide decreases in the combined Federal-State-local tax burden. Thus, per dollar of cost to the Federal Government, such a credit would provide less aid to State-local governments than would direct Federal grants.

The greatest revenue benefit, in terms of free revenue, would accrue to those States which do not as yet impose income taxes. For plan 5, the 17 States without income taxes could receive 75 percent of total free revenue (estimate for 1958); and for plan 6, these States could receive 75 to 85 percent of total free revenue.

The direct revenue benefit from such a credit would go entirely to State rather than to local governments, but local governments probably would receive increased State aid. It has been argued that because of the underrepresentation of urban areas in State legislatures such areas would not receive their fair share of the increase in State aid to local governments. But recent court decisions which are forcing reapportionment of State legislatures should result in a more equitable distribution of State aid.

The credit approach represents a combination of freedom and coercion. It would strongly encourage if not force those States not having State income taxes to adopt them. In addition, it would have some effect upon the tax structures of States already having income taxes. On the other hand, such a credit would increase somewhat the financial independence of State governments by enabling them more fully to exploit their tax bases. The credit would leave room under State income tax laws for variations in definitions of income, exemptions, tax rates, and so forth. Furthermore, States would be free to differ in their degrees of reliance upon State income taxation. All in all, such a credit offers States a large gain in fiscal independence in exchange for a relatively small loss in freedom of tax action. The element of Federal control involved in such credit proposals would be small compared to that involved in *conditional* Federal grants programs, but not small compared to that involved in an *unconditional* Federal program.

The credit could be a constant-percent credit or a sliding-scale credit. Since free revenue would accrue largely to the States without income taxes, for two credits of equal maximum cost free revenue would be only slightly larger for the sliding-scale credit than for the constant-percent credit. The sliding-scale credit would be only slightly more favorable to the poor States and only slightly less favorable to the rich States than would the constant-percent credit. A sliding-scale credit, moreover, would decrease tax progression less sharply than would a constant-percent credit. While the balance of these differences favors the sliding-scale credit, a choice between them is not a matter of crucial importance.

The present treatment of deductibility is a source of considerable inequity and an ineffective means of aiding State-local governments. To improve tax equity, deductibility should be removed. To secure a more effective means of aiding State-local governments, a credit for State income taxes and/or a program of *unconditional* Federal grants should be introduced.

Part 5

TAX REDUCTION

THE FEDERAL EXPENDITURE EXPLOSION *

BY ARTHUR F. BURNS

THIS ISSUE IN BRIEF

Not counting Federal Government spending attributable to Vietnam between 1965 and 1968, we are still left, says Dr. Burns, with a spending increase 2½ times as large as the annual rate of increase in total Federal spending in the 1962–65 period.

He advises: (*a*) that Congress make a "strong and determined effort" to curb new appropriations so that when the Vietnam conflict ends, we can return to a tax-reduction policy; (*b*) that any increased social security benefits this year be limited to the level justified by current employment taxes, and (*c*) that Congress take no action "at present" on the recommended 6 percent income tax surcharge plan. He recommends watching economic and fiscal trends over the next few months and then judging the tax issue in the light of developments.

We are now in the midst of a tremendous upsurge of Federal spending. According to the national income accounts budget, for which the President has recently expressed a preference, Federal expenditures in fiscal 1965 amounted to $118 billion. In fiscal 1966, expenditures reached $132 billion. Now, a total of approximately $154 billion is projected for this fiscal year and a total of $169 billion for fiscal 1968. The successive annual increases thus come to about $14, $21, and $16 billion, an overall increase of $51 billion in just 3 years.

This growth in spending represents a violent break with the past. From 1960 to 1965 the increase in Federal spending averaged $5.4 billion per year. From 1955 to 1960 the average annual increase was $4.8 billion. Now, according to the President's budget, the increase from 1965 to 1968 will reach $17 billion per year. That is more than three times the rate of increase experienced during the preceding decade.

Of course, the upsurge in Federal spending is to a significant degree attributable to the war in Vietnam. In fiscal 1965, expenditures for the support of Vietnam operations were negligible. In fiscal 1968, they are expected to reach $22 billion. This is a very heavy cost, but it accounts for less than half of the $51 billion increase in Federal spending between 1965 and 1968.

If we put aside the spending attributable to the war in Vietnam, we are still left with an increase of $29 billion between fiscal 1965 and fiscal 1968, or an annual increase of about $10 billion. This is two-and-a-half times as large as the annual rate of increase in *total* Federal spending during the 3 preceding years, that is from fiscal 1962 to fiscal 1965.

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Clearly, neither the war in Vietnam nor, for that matter, total defense expenditures are a sufficient explanation of the spurt in Federal spending that got underway in 1965.

Information concerning Federal expenditures is not provided in much detail by the national income accounts budget. There is, however, a table in the budget message which, while confined to the short interval from fiscal 1966 to fiscal 1968, reveals the general character of our present expenditure policy.

This table, given on page 43 of the document entitled "*The Budget of the United States Government: 1968*," shows expenditures for each of a dozen functional categories. One of these is national defense, another is international affairs and finance, and so on. The table discloses a projected decrease for only one category, space research and technology, between fiscal 1966 and fiscal 1967, and it is a small decrease at that. Between fiscal 1967 and fiscal 1968, there are two projected decreases, both small.

Problem for Congress To Inspect Spending

No one reading this table, or the budget message as a whole, can very well escape the impression that Federal spending is now growing in nearly every direction.

When a nation's budget gets into such a condition, the first and foremost necessity facing the Congress is to subject every expenditure program to the most searching reexamination.

For, unless a determined effort is made by the Congress to check the proliferation of Federal spending, the foundations of our economy may be weakened. With public revenues increasing rapidly in these good times and the public debt still growing, there is a danger that scarce resources are being applied to projects of marginal or even doubtful value. Not only that, but the recent spurt in public spending is bound, sooner or later, to lead to higher taxes. This already happened last year and the President is now requesting additional tax increases.

Private Sector Provides Strength

I firmly believe that the main strength of our economy comes from the resourcefulness of private enterprise, and that we must guard against the weakening of incentives that occurs when an excessive portion of people's income is siphoned off in higher taxes. Only a short time ago this was also the belief of the Congress.

Let me remind you of the great fiscal debate that stirred our Nation during 1963. Some citizens urged that the Government seek to stimulate the economy by larger Federal spending. Others argued for tax reduction. Still others urged that we travel both roads at the same time. President Kennedy belonged to the latter group, but he put much the heavier emphasis on tax reduction. Even so, the Congress balked.

In the revenue bill passed by the House in the fall of 1963, Congress took the unusual step of spelling out its fiscal philosophy. The preamble of this bill explicitly assigned top priority to tax reduction, with debt reduction next. Congressman Wilbur Mills described the

preamble as a "firm, positive assertion" that the nation is choosing tax reduction, and rejecting larger spending, as its "road to a bigger, more progressive economy." President Kennedy accepted this declaration of policy. So, too, did President Johnson. His first budget message, presented in January 1964, called for smaller expenditures under the administrative budget in fiscal 1965 than in fiscal 1964. With this much assured, the Senate promptly passed the House bill with only minor revisions.

In line with the new fiscal policy enunciated in the tax reduction bill, Federal spending actually stopped rising for a time. From the third quarter of 1963 to the first quarter of 1965 cash expenditures moved along a horizontal trend. Then, despite numerous signs of pressure on available resources, spending began to climb again. Expenditures rose rapidly both for defense and for civilian programs.

Since the economy was already booming in 1965, Governmental revenues also rose, but the increase was held in check by new tax reductions. The deficit mounted, and this fresh injection of money into the economy was reinforced by a great wave of spending and borrowing by business firms and consumers.

As was bound to happen, the economy became overheated in the process. To be sure, when 1965 ended, the unemployment rate was finally down to 4 percent. But the widespread exuberance of both public and private spending produced also other and less welcome results—in wholesale markets, prices that were 4 percent higher than in mid-1964; in consumer markets, prices that were nearly 3 percent higher; in the labor market, wages that were beginning to rise at an accelerated rate; and in the money and capital market, interest rates that were moving up sharply, despite an enormous expansion in the supply of credit.

Much has been said and written about the causes of the recent inflation and distortion of our economy. In particular, the Government has been blamed for not raising income tax rates at the beginning of 1966. But I believe that the fundamental mistake of policy was made in 1965, not in 1966. It was in 1965 that we pursued boldly and simultaneously a policy of tax reduction, accelerated spending, and credit ease.

Federal Reserve Shifts Policies

Certainly, both monetary and tax policy moved toward restraint last year. In the spring, the Federal Reserve authorities shifted to a policy of credit restriction quite bluntly. Changes on the tax front were much less dramatic, but their significance should not be underestimated. Higher social security taxes went into effect at the beginning of the year. A little later some excises were raised, and in the fall the investment tax credit was suspended. Income tax rates remained nominally constant, but they rose in real terms as a consequence of applying a progressive tax schedule to inflated incomes. This January, social security taxes were lifted another notch.

The President has now proposed additional increases in tax rates. The most important of these are, first, a surcharge of 6 percent on the income tax liability of individuals and corporations, starting July 1, second, an increase in the social security tax on January 1, 1968

and again on January 1, 1969. These tax recommendations are obviously related to the administration's spending plans. In particular, the higher social security tax is directly linked to the higher social security benefits that the President has recommended, with the first hike in the tax coming 7 months after the benefits are to be lifted.

Must Take Account of Tax Burden

In judging the President's new tax program, it is necessary to consider not only the wisdom of the proposed expenditure plans, but also the magnitude of the tax burden that is already borne by the American people.

Our gross national product in 1966 was about $58 billion larger than in 1965. Federal revenues, according to the national income accounts, were $17½ billion higher. Thus, the Federal Government absorbed 30 cents out of every additional dollar of gross national product. The States and localities took another 10 cents. Thus, taxes siphoned off 40 percent of the increment of the gross national product last year. During the past dozen years or so, this figure was exceeded only in 1956 and in 1960. It may not be entirely an accident that these years were followed by recession.

In 1963, when the administration urged a massive tax reduction, it rightly put great emphasis on the fiscal drag on the economy caused by our tax system. The argument was that the tax system draws off so large a portion of a rising national income that it tends to choke off the process of expansion. Yet, in 1963, Federal revenues absorbed only 27 cents of every additional dollar of gross national product, in contrast to 30 cents in 1966.

If our economy in the years ahead is to grow and prosper, as it both can and should, we will need the stimulation that comes from an improving tax climate. Unhappily, under present circumstances, tax reduction is impracticable. But we should at least try to avoid tax increases, and we can do so by curbing the growth of Federal expenditures.

If increases in social security benefits are kept within modest limits, there will be no need for any early increase in employment taxes. And if the growth of other Federal civilian programs is moderated, there will be no need to raise income taxes this year.

One Sure Weapon in Poverty War

I realize that the rapid growth of civilian expenditures is often defended on the ground that we have excessive poverty in our land of plenty. But I know of only one sure weapon for waging successful war on poverty; namely, full employment together with rapid improvement in the productivity of labor. This should be our prime economic objective. I am inclined to doubt if the increase in Federal aid to the poor from $13 billion in fiscal 1963 to $22 billion this fiscal year has really done very much for poor people.

Let me now turn from these basic and long-run considerations to the question of how an increase of income taxes, such as the President has recommended, would affect economic activity this year. The argu-

ment of the Council of Economic Advisers appears to be that the private economy may be moving ahead "too rapidly" in the second half of the year and that the "President's tax program will be moderating the advance."

This is sheer conjecture. Neither the Council's ability in forecasting, nor that of other competent economists, is sufficiently good to attempt such delicate, pin-point prediction.

The Council has itself recognized that there are forces that may make for sluggish private demand in the first half of this year. In my judgment, doubts about the short-term economic outlook extend beyond the next few months.

The economy is now full of crosscurrents. On the one hand, the aerospace and machinery industries are continuing to boom. On the other hand, the homebuilding industry is experiencing serious depression. There is also noticeable weakness in the building materials trades, in the automobile industry, in the appliance trades, in the steel industry, and in the textile-apparel-leather sector. The curve of total industrial production has flattened out. In the first quarter of last year, the production index rose about 3 percent, in the second quarter 2 percent, in the third quarter only 1 percent. In the last few months the index has not risen at all.

Price trends have also become mixed. Consumer prices are continuing to rise at a disconcerting pace. On the other hand, wholesale prices of farm products and industrial materials have weakened, while the rate of advance of prices of finished industrial products has appreciably slackened.

Meanwhile, the advance in wages has accelerated. Lately, the rate of increase of output per man-hour in the economy at large has not only slowed down, but has fallen below the rate of increase in wages per hour. Hence, the labor cost per unit of output, which was so remarkably steady in recent years, is now rising. Precise measurements of this ominous development do not exist; but the available data suggest that unit labor costs are now 3 or 4 percent higher than a year ago. As a result of the divergence in industrial prices and production costs, corporate profit margins have been shrinking during the past 9 to 12 months. More recently, total corporate profits have begun to slip.

New Restraints on Investment

With the scope of economic expansion narrowing, with labor costs rising, with profit margins shrinking, with construction costs high and running well above investors' estimates, with interest rates on business loans still relatively high, with the stimulus of the investment tax credit suspended, and with the business and investing mood gradually becoming less exuberant, powerful forces are now operating to restrain business investment. New investment commitments appear to be waning. Of late, anticipatory indicators of business capital expenditures, such as the formation of new firms, orders for machinery and equipment, commercial and industrial construction contracts, and new capital appropriations, have all been displaying some weakness.

Other branches of private investment also lack vigor at present. In many industries, manufacturing and distributing firms feel a need

to bring down the ratio that inventories bear to sales. Hence, inventory investment is likely to move to lower levels this year. To be sure, the recent easing of credit should in time lead to improvement in the homebuilding industry, but as yet it has not had a significant impact on the mortgage market. In the best of circumstances, several months will need to elapse before expenditures on residential construction can recover from the drastic decline in building permits last year.

Families Must Practice Economy

The prospects of consumer and export markets are also not especially bright. Retail sales have been sluggish of late, and surveys of consumer buying intentions suggest that this condition may well persist for a time. One clear reason for the sluggishness is that many families are forced by the rise in the cost of living to practice stricter economies. As far as exports are concerned, they will probably continue to grow at a moderate rate. But a rush of export orders is highly unlikely, since the rate of expansion is slowing down materially in the world economy, not only in our own.

In view of the slackening of demand pressure that is so evident in the private economy, the economic case for an income tax increase is weak at present. Such a measure, if adopted early in this session of Congress, could tip our delicately poised economy toward recession despite the strong upward trend of government spending.

In expressing this judgment, I am not unmindful of the continuing threat of inflation. Demand is no longer pulling up prices as it did a year ago, but higher costs are tending to push up prices.

Workers and their leaders are insisting on much larger wage increases than have recently been customary. The wage push will continue, as workers seek to adjust to recent trends in profits and prices, and it will gain strength from the increase of the minimum wage that Congress recently legislated. Hence, the troublesome advance of the consumer price level, which reflects higher labor costs directly as well as indirectly, will continue this year; but the prices of industrial products in wholesale markets will probably rise much less.

The scope of constructive governmental action for dealing with the present price and cost inflation is, I think, quite limited. Unhappily, even a mild recession would probably not suffice to bring cost inflation to a halt under current conditions. The reasons are all the stronger, therefore, for avoiding governmental measures of an inflationary character.

In dealing with the President's legislative recommendations, it is particularly important to consider the psychological impact of a 20 percent boost in social security benefits, besides the fiscal implications and the direct economic effects. It would not be unreasonable for working people to feel that if retired folk are entitled to a 20 percent increase in the income put at their disposal by the government, then those who are productively engaged deserve more than just a 5 or 6 percent increase in wages.

In summary, my advice to this committee on the fiscal issues that now face our Nation is as follows:

CURBS NEEDED ON MONEY BILLS

First, it is highly important that the Congress make a strong and determined effort to curb new appropriations and thereby pave the way for an early return, once the hostilities in Vietnam make this possible, to the policy of tax reduction which served our Nation so well from 1962 to 1965.

Second, any increase in social security benefits this year should be limited to the level justified by current employment taxes.

Third, the Congress should take no action at present on the President's recommendation of a 6 percent surcharge on the income tax liability of individuals and corporations. The wise course would be to watch economic and fiscal trends closely over the next few months and judge the tax issue in the light of developments. If it should become clear several months from now that the pace of economic expansion is again quickening, an increase of income taxes may become necessary, especially in case little progress is in the meantime made by the Congress in scaling down requests for new appropriations. On the other hand, if signs of weakness in the economy multiply, the case for a tax increase will become even more doubtful than at present.

But if the Congress is to be adequately informed, the flow of fiscal information will need to be improved. This need extends, of course, beyond the immediate future and beyond the halls of Congress. Just as the Federal Government now makes public each quarter the information that it compiles on business sales expectations and investment intentions, so it should also compile and make public each quarter its estimates of the Government's own revenues and expenditures. These reports should include fiscal projections both for the ensuing quarter and for the remainder of the fiscal year.

I hope that the Congress will consider legislation to this effect in the interest of keeping itself, as well as others both within and outside government circles, adequately informed. Once this new fiscal tool becomes generally available, we will be better equipped as a society to deal with the difficult and changing requirements of fiscal policy.

FEDERALISM OR FEDERALIZATION*

BY ROBERT C. TYSON**

THIS ISSUE IN BRIEF

The impact of inflationary deficit Federal spending—which Mr. Tyson says could be diminished by cutting nondefense spending—is not the only problem arising from central government expenditures.

He fears that continuation of the Federal grants-in-aid to States may undermine the constitutional structure of our sovereign states. He urges "long and careful consideration" of the question of whether aid and control can somehow be separated; of whether the Federal Government through aids can revitalize federalism; of whether it is desirable to place local spending in hands freed from providing the income for that spending. He suggests that a careful look be taken at proposed Federal-State "tax sharing" plans. He believes that growing Federal aid marks a trend in government from federalism to federalization, from decentralization to centralization.

I believe the time has come in fiscal affairs when we Americans should reexamine the roots of our political existence and the relations between the Federal Government and the States; when we should take an accounting of where we have been, where we are and where we are heading—if we are to preserve a free society.

Certainly, taxing and spending have strong implications for freedom. They involve power—political and economic power—potentially constructive power in view of the necessary roles that all levels of government have to perform, yet also potentially corruptive and destructive power. As Chief Justice John Marshall noted a century and a half ago, the power to tax involves the power to destroy. Thus I believe that power to tax and power to spend should be contained within the constituional design of limited government, of checks and balances and, importantly, of federalism.

As you know, the framers of our Constitution clearly intended federalism as a system in which the States would remain sovereign except as to that part of their sovereign powers which they delegated to the Federal Government. Witness the 10th amendment to the Constitution: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

This and other constitutional prohibitions on the Federal and State governments further point up the concept of limited government, of divided Federal-State powers, of the retention of vital rights, of personal sovereignty by the people, by the individual.

It is through the individual that the most productive system the world has ever known grew and prospered. This economic growth has sprung from a fortuitous combination of incentives—incentives to work, to save, and to invest—by which generations of Americans have built up our vast store of high-productivity yielding capital.

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**Chairman, Tax Foundation.

So those in political life should keep in mind how we achieved our economic legacy, and those in economic life should keep in mind how we achieved our political legacy.

I believe, in other words, that businessmen can properly recognize that good government is essential for good business; and our leaders in public life can properly recognize that good business is necessary for good government, and that government is not so much a producer as a consumer, a growing consumer—in fact, government at all levels will consume about $170 billion of goods and services in 1967. In addition to this amount, Government also serves as a transfer agent, currently disbursing over $40 billion a year through social security and other public programs to some 25 million Americans, mostly in monthly payments.

Projected Cash Budget Deficit Will Be Ninth in 10 Years

Public spending in such magnitudes and in such ways should jar the easy assumption that our free competitive enterprise system of incentives to produce can still remain unimpaired, that our present and future production is unaffected, that our system of federalism and limited government is safe and sound.

Nor is our Nation so affluent that it can afford everything anyone needs or desires, including the "elimination" of poverty, of urban blight, of traffic congestion, and of air and water pollution—practically all at once. This assumption seems to underlie recent "guns and butter" Federal budgets, including the one proposed for fiscal 1968.

But Washington, like States, localities, and the rest of us, is not immune from assigning priorities to its programs; it, too, is subject to the economic law of opportunity cost—the fact that spending a dollar in one place precludes its being spent in another, the fact that as the public sector expands at a faster pace than the private sector, the private sector shrinks relatively.

Consider that the Federal Government, in the single year starting next July, proposes to spend the grand sum of $172 billion, defense and nondefense, according to the cash budget, while it anticipates cash receipts of some $168 billion. Thus this budget projects yet another cash deficit, the ninth in 10 years. Over that time Federal expenditures *will have increased over 100 percent*, the major part of the increase going to finance *non*defense activities. The Federal fiscal 1968 budget thus repeats an old story: higher spending, higher taxes, more red ink, probably more inflation.

The budget message discusses three different ways of calculating the deficit. But, if past experience is any guide, the official projected deficit for fiscal 1968, whether the national income accounts deficit of $2.1 billion, the cash budget deficit of $4.3 billion, or the administrative budget deficit of $8.1 billion, may well be understated, if the proclivity of Congress for "add-ons" to administration requests for budgetary authorizations is not otherwise offset.

Participation Certificate Sale Seen Alternative to Added Taxes

There are other questions on the extent of the 1968 deficit. Additional revenue of some $5 billion is expected from a recommended 6-percent special Vietnam income tax surcharge on individuals and cor-

porations. But Congress, mindful of the current business uncertainty and of the fact that higher rates could boomerang into lower revenues, may hesitate on this proposal.

Another question lies in the aforementioned business outlook. The budget assumes that the long economic expansion will continue, if at a slightly slower pace. But if the economy should sag, the Treasury's cash receipts will be substantially less than expected.

Still another question lies in the proposed offer of $5 billion of "participation certificates" backed by Government-held assets. This offer is reflected as an offset to proposed spending in the cash and administrative budgets. It is thus merely an alternate to additional taxes or to other forms of Federal borrowing pressure on capital markets that have been tight.

The expected deficit could actually rise to as much as $20 billion or more in the 2 years ending in June 1968. But whatever the deficit amount, it will have to be financed. If a demand of such magnitude were pressed on America's capital markets to finance the deficit spending, it could lead to another monetary crisis, soaring interest rates, and a drying up of new bank loans, as we witnessed last year. This is exactly what the Government wishes to prevent.

Could Cut Deficit Spending Impact by Nondefense Spending Slash

More likely there would be resort to deficit financing by the expedient of the printing press. Just as in past similar situations, the Federal Reserve would probably purchase billions of dollars of new Government debt in the next year or so, and this purchase would form the base on which commercial bank credit could be greatly increased and the money supply expanded at an excessive pace. As the money supply expands faster than production, prices would strongly tend to be pressed upward.

Yet the impact of inflationary deficit spending could be diminished if only we would cut back on nondefense spending. I believe such a cutback can and should be accomplished. Federal nondefense spending is now officially projected at $96 billion in the 1968 cash budget, an increase of $30 billion, or 45 percent, just since 1964. It is here, in nondefense spending, where we must seek outlay reductions or deferments in order to maintain the integrity of the dollar.

Inflation is not the only problem emanating from surging Federal spending. I am concerned that the constitutional structure of sovereign States may be undermined. Earlier this year a Governor of an industrial State suggested that unless the Federal Government were to increase its aid, our States may go under. Mayors have long echoed a similar plaint for their cities, where, then, is the route of Federal grants-in-aid taking us? I call your attention to a passage in the state of the Union message last January. It is:

"During the past 3 years we have returned to State and local governments about $40 billion in grants-in-aid. This year alone 70 percent of our Federal expenditure for domestic programs will be distributed though the State and the local governments. With Federal assistance, State and local governments by 1970 will be spending close to $110 billion annually. These enormous sums must be used wisely,

honestly, and effectively. We intend to work closely with the States and the localities to do exactly that."

I would suggest long and careful consideration of the question of whether aid and control can somehow be separated, of whether the Federal government can revitalize federalism by helping States and localities make ends meet, of whether it is desirable to place local spending in hands freed from providing the income for that spending. In fact, I am very much concerned with the potential abuse of the power of the purse. Through this power the Federal Government can and does influence State and local action, causing our citizens to increasingly look not to the city or town hall, nor to the State House, but to Washington. The disconcerting thing is that this influence is accomplished with money originating in the States and localities themselves.

Now we hear increasing calls for still another system of Federal aid—so-called tax sharing to supplement "help" for States and localities.

Doubts New Federal Aid Plan Would Be More Efficient

Tax sharing is a form of "unconditional" grants as opposed to the usual conditional grants-in-aid. Numerous advantages are claimed for the new "unconditional" plan. Many who advocate progressive rates of tax say that such aid would slow down increases in property and sales taxes, which they claim to be oppressive or regressive. Also, it is said that there is a net saving in having the Federal Government more efficiently collect and share rather than have the State undergo the collection expense. This claim of efficiency made by some advocates of new supplementary Federal aid looks a bit strange in the light of the present Federal tax and aid setup. For already aid to States and localities, according to *Time* magazine, "is distributed among 170 separate programs, funded by 400 different appropriations, administered by 21 departments and agencies, assisted by 150 bureaus." To further assist our citizens in their quest for Federal largesse, the U.S. Office of Economic Opportunity has made available a 414-page "Catalog of Federal Programs for Individual and Community Improvement," which carries brief descriptions of more than 260 different programs.

One theory behind tax sharing is that State and local governments supposedly become poorer as they meet the demand for services, while the Federal Government becomes richer as yields from income taxes rise. A simple solution to such a theoretical windfall of riches might well be to reduce Federal income tax rates again, but that kind of fiscal dividend no longer seems to appeal to those who apparently regard State and local governments as "poverty pockets."

Americans Believe Social Problem Solving Done Best at Local Level

This is why I say, let's stop, look, and listen. No Government has money to give that is not first taken away. Federal funds are not free funds. In my judgment, growing Federal aid poses a problem to freedom and free competitive enterprise. It marks a trend in Government

from federalism to federalization, from decentralization to centralization. Through mounting aid, the Federal Government saps the vitality of our State and local governments and, I think, the vitality of our constitutional heritage as well.

Moreover, in weighing the matter of tax sharing, there is another major consideration. It is the dismal assumption that State and local governments are on a fiscal collision course—with demand for services rising faster than financial resources. How valid is this assumption? Appropriately, the Tax Foundation has just released a new study, *Fiscal Outlook for State and Local Government to 1975*. Based on present economic and population trends, the study concludes that the States and localities *can* meet their financial challenges without extensive new tax-raising measures and without new supplementary forms of Federal aid such as tax sharing.

To be sure, States and localities will be spending more. The Tax Foundation study anticipates an expansion of State and local spending from $75 billion in fiscal 1965 to over $140 billion in fiscal 1975. But the indicated spending increase of about 90 percent is at least less than the 122-percent increase in the 1955–65 decade.

On the revenue side, the Foundation study indicates that State and local general revenues in the next decade will rise somewhat more rapidly than general spending due to economic expansion and without any increase in overall tax rates. Findings in the study indicate a 75-percent rise in tax yields from the existing State and local tax rate structure in the decade ahead, despite the alleged relatively low revenue-yielding State tax system. In addition, existing forms of Federal grant-in-aid programs are estimated to increase from $11 billion in 1965 to $30 billion by 1975. While I may not endorse this rise, it is at least a relatively slower rate of increase than in the past decade; and the projected aid is large enough to more than meet anticipated spending demands when combined with revenues from State and local sources. I conclude from this study that resort to supplemental Federal revenue sharing or tax credit schemes is unwarranted as evidenced by the projected spending and revenue requirements.

The trend to an increasingly centralized society is not, I believe, the intention of the American people nor of most of their elected representatives. The Gallup Poll has just released the results to its question of which government spends the taxpayer's dollar more wisely—State or Federal. Respondents replied nearly 3 to 1 in favor of State—49 percent for State, 18 percent for Federal, 33 percent did not respond to the question, although half of this group answered "neither."

These results make it evident the American people hold to the principle of federalism, to the principle that the States are not mere administrative districts of the Federal Government, but sovereign political entities responsible and responsive to the citizens they serve.

And I believe the American people hold to the principle of governmental subsidiarity—namely, that social problem solving is usually best accomplished locally and regionally: it should be shifted only to higher authority when lower authority is clearly and demonstrably inadequate. Or, as Jefferson noted: "Were not this great Country already divided into States, that division must be made, that each might do for itself what concerns itself directly, and what it can so much better do than a distant authority."

STATES AND SURPLUSES*

WHY FEDERAL "NO STRINGS" DISTRIBUTIONS WOULD BE UNWISE

BY HARLEY L. LUTZ**

It has recently been proposed that the Federal Government should distribute its surplus revenue among the States. Those whose knowledge of the Federal finances is limited to the facts of the record might well ask "What surplus?" From fiscal year 1930 through fiscal 1965 there have been only 7 years with budget surpluses. The aggregate of these surpluses is $27.6 billion. The deficit total for the same period, excluding the war years, is $80.7 billion. Offhand, the proposal is reminiscent of the old recipe for rabbit stew, which is "First, catch a rabbit."

The plan is a product of the optimism generated by the anticipated effects of the combination of tax cut and budget deficit. The Government planners believed that the thrust of this combination would send the economy into orbit and that the rate of economic expansion would shortly be high enough to produce revenues in excess of spending. It was said that a budget surplus would be a tax drag on the economy and the way to avoid the drag would be to cancel out the surplus as it appeared by distributing it to the States. In this way the funds would be kept in the mainstream of spending.

On its face, the proposal would appear to be so preposterous as not to warrant consideration. It has had, however, a certain amount of official recognition and sponsorship, and the following discussion deals with various aspects of the case.

The Prospect of a Surplus. The assumption that a budget surplus is just around the corner ignores the "propensity to spend," an occupational disease that afflicts many Members of Congress and of the Executive branch. The President recently reported that the departments and agencies had requested $108 billion of new authority to spend for the budget year 1966. How deeply the Budget Bureau and the Appropriations Committees will cut these requests remains to be seen. In the same statement the President expressed concern that it might not be possible to hold the budget within the "magic figure" of $100 billion in view of these pressures.

The Defense Department's program for phasing out unneeded installations and facilities has already run into trouble. The application of savings at one point to another "essential needs" has long characterized budget management and there is no indication that this policy has been abandoned. No one in the Government is willing to predict even a balanced budget before 1967 or 1968 and these are by no means firm dates. No date thereafter has been set by anyone for the realization of

* Reprinted from *Wall Street Journal*, Dec. 28, 1964.

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a surplus large enough to warrant distribution. All talk now about what to do with a budget surplus is a purely academic exercise.

It is worthwhile, however, to examine the relative worth of this method of disposing of a surplus and the theory of government that would appear to underlie the proposal.

Federal-State Fiscal Relations. Federal donations to the States, commonly known as grants-in-aid, have been made over a long period for an ever-expanding array of purposes. In recent years the States have been bypassed by making grants directly to cities and other local units. The original idea of a grant was that it would motivate and activate the States accepting such offers to embark on programs deemed, by some central planning agency, to be in the national interest. Once launched under the Federal stimulus, it was believed that the States would continue to operate and pay for the programs of their own accord.

This notion was soon dispelled. Using a parallel from our tariff experience, the "infant" programs, like the "infant" industries, never became sufficiently mature to carry on without the Government crutch. In the case of the grants, the Federal Government has been no more willing than the States to terminate them. The Federal grants have become a useful and efficient instrument with which to extend Federal jurisdiction into areas of State and local function and responsibility.

The grants are not a distribution or sharing of surplus revenues. Rather, the grant total has steadily increased, especially since World War II, despite the budget deficits. Indeed, there has never been any thought, as the grant total has risen year after year, of relating either the amount or the purposes of the grants to the budgetary situation. It would be futile to contend that the grants were the cause of the deficit for the same could be said, with no greater validity, of any other expenditure purpose involving a substantial amount.

No Strings Attached

The proposal under discussion differs, in one respect, from the existing grant system. It would be a distribution to the several States with no strings attached. The present grants are made for specific purposes and at least enough Federal inspection and control are exercised to assure State or local compliance. In a large proportion of the present grant programs, some participation in the cost is required from the recipient governmental unit.

The proposed distribution would be a "block" grant—that is, one with no restrictions on its use. Introduction of a block grant or "no strings" system need not be deferred until there is a budget surplus. It can be substituted for the present system at any time by act of Congress. In support of an unrestricted grant, to be spent at the discretion of the grantee, is the argument that State and local administrators know, better than any Federal official or Congress, what the local needs are and can therefore make better use of the funds if left to their own judgment.

Against the unrestricted grant it is argued (1) that there is a Federal obligation to set rules and conditions for the use of the funds, (2) that the States or localities should not be released from the obli-

gation to provide some part of the cost, and (3) that unconditional grants might be used for purposes that have not been approved by Congress or the courts as a proper application of Federal funds. A case in point is the issue of Federal aid to parochial schools.

These arguments point up the basic weakness of any Federal grant system. The State and local officials do know best what their local problems and needs are. The conditional grants at times force them to divert their own funds into programs which, in their judgment, have a lower priority than others. They are not really forced, but they accept the Federal decision in order to get what is generally regarded as "free" money. This supposedly free money is more likely to be used extravagantly or wastefully than would be the case if the people were more directly aware of the tax cost.

A distribution of "no strings" money would lack even such inducement to prudence as may be provided by the matching requirements of the present system. It is natural that the higher the Federal proportion, the brighter is the aura of free money. Federal public assistance grants are heavily weighted in favor of the low-income States and in some of these are correspondingly slack standards of eligibility. The Government provides 90 percent of interstate highway funds, which may explain the scandals that have broken out in this area. The proposed distribution of surplus revenues, like any other block grant, would be 100 percent free money.

A DIFFERENCE IN PRIORITIES

Despite the strong entrenchment of the Federal grant system, it would be better in the long run to aim at terminating instead of extending it as the proposal considered here would do, and to reduce the Federal tax load correspondingly. In this way leeway would be provided for the several States to apply their own fiscal resources to local needs without central supervision or dictation. They would not all do the same things. Priorities would differ in different regions, and so would the financing and administrative procedures.

The disposition of surplus revenues in 1836 is not a valid precedent for the present proposal. The public debt had been fully paid off in 1835. The revenue surplus in 1836 was produced by a large increase of customs receipts and a sharp rise in public land sales. These were then the two major sources of Federal revenue. Protectionist sentiment prevented reduction of tariff rates and the Western States opposed restriction of land sales. The money was not legally donated to the States but deposited with them on condition of repayment at the Treasury's call. Meantime, they were privileged to use the funds as they saw fit. None of it was repaid and most of it could not have been for it was lost in unwise loans and State ventures, or applied to current expenses. Maine distributed part of her share on a per capita basis.

Daniel Webster supported the distribution as the only solution of a critical situation, but he said: "There would be insuperable objections to a settled practice of distributing revenue among the States. I cannot reconcile myself to the spectacle of the States receiving their revenue, their means of supporting their own governments, from the Treasury of the United States."

Webster's concern about the effect on our system of government was prophetic. The policy of distributing Federal funds to the States, whether out of surplus deficit, has profoundly affected our governmental system by upsetting the balance of power and responsibility intended by the Constitution. As the Federal grants expand the States become more dependent on the Central Government. To complete the vicious circle, Federal tax collections must be kept at a higher level in order to pay the grants. With increasing State dependence goes greater State vulnerability to Federal coercion. The threat to withhold funds is usually sufficient to assure complete compliance with the Federal will.

Other Ways of Dealing With the Budget Surplus. Other courses of action than distribution are obviously available in the remote and somewhat improbable event of a sizable budget surplus. A respectable body of opinion can be mustered in support of paying something on the public debt. This was a fashionable financial policy in the "dear dead days beyond recall." In addition to being entirely out of debt in 1835, the Civil War debt had been redeemed by the 1880's except for small issues maturing in the 20th century. In fact, there was a flare-up of agitation over the surplus question around 1883.

Between 1920 and 1930 some $10 billion, or roughly two-fifths, of World War I debt was retired. A cynic might say that the saving and sacrifice of debt reduction was in vain because national debts everywhere are higher than ever despite the heroic efforts in the past to reduce them. But the debt payments strengthened national credit so that when other emergencies came their financing was less of a strain on credit resources and on the monetary unit than it otherwise would have been.

Beyond question, debt reduction is an outstanding candidate for the use of any budget surplus that might be realized. Our Federal debt is now so large that, with the best of intention and the best of luck, only a small dent can be made in it by any generation of taxpayers. The most valuable contribution of a policy of debt payment would be a reaffirmation before the world of our respect for the debt obligation, and evidence of our pledge that the bondholder shall not be cheated of his investment in his country's future by inflation and its aftermath of devaluation.

Tax reduction is a solution of the surplus problem that would also have substantial support. The fact of a surplus would be evidence of the suspension of Parkinson's law to the effect that expenditure rises to meet income, in itself a feat of heroic dimensions. With the present incomprehensible Tax Code, tax reduction could be a slow, dismal process, but under a simpler tax structure rate changes that would adjust revenues to expenses could be made quickly.

There would be occasions when the condition of the economy would give priority to debt reduction and others when tax reduction would have first call. Both steps have merit under the appropriate conditions. Either one would reflect confidence that the private economy can support both the people and the Government. Either one would be a decisive move against the further centralization of power in the Federal Government, and would be, by so much, a correction of the distortion of the Constitution which the plan of distributing surplus revenues to the States would perpetuate.

THE DIALOG GROWS*

BY THE TAX COUNCIL

With recent speeches by Secretary of the Treasury Henry H. Fowler, Ways and Means Committee Chairman Wilbur D. Mills, and Council of Economic Advisers Member James S. Duesenberry, the dialog on tax reduction when the military situation permits is greatly enriched. The purpose of this bulletin is to review these and kindred expressions for using revenue growth to reduce taxes, and to identify some of the relevant facts, and the critical questions, which will arise as the dialog proceeds.

SUMMARY

1. The expressions to date convey a welcome picture of lower taxes after peace comes in Vietnam.
2. As the dialog grows, the critical questions will involve the size of tax reductions, the distribution among taxpayers of the relief to be granted, and the method or methods to be used.
3. The range of reduction possibilities is indicated by the annual revenue growth of $7 to $9 billion or more in the contemporary era, and the probability of military cutbacks from $10 to $20 billion after Vietnam.
4. The high-level commitment heretofore made to emphasize relief for low-income people in the next tax reduction could be satisfied by increasing the minimum standard deduction, or by other means, while still pursuing a program of rate reform.
5. The curve of graduation would be transformed into a relatively straight line, as recommended by the Tax Council, by adding only about $2.2 billion to the revenue cost of a 32.5-percent cut across the board.
6. There are at least four options on method of tax reduction (listed herein).
7. Moderation in the rate of graduation would be a popular public policy.

DISCUSSION

Until the early 1960's, the prevailing attitude in official Washington was that tax reduction had to be earned by expenditure reduction, or traded for by the elimination of special provisions in the tax law. When trial balloons on a "quickie" tax cut were launched in the late spring of 1962, the initial thought was that the cut should be temporary, providing a shot in the arm to a lagging economy. By the time that tax reduction was brought to legislative issue in 1963, the emphasis was on a permanent cut to be financed out of revenue growth. The logic was that

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tax reduction would induce greater growth and thus provide the revenues to finance the reduction.

Visualizing the benefits from tax reduction.—The case for a stronger economy through tax reduction was well documented in the hearings held by the Ways and Means Committee. When the legislation cleared the Committee in September 1963. Chairman Mills described in visionary terms the benefits which would flow from enactment:[1]

> The purpose of this tax reduction and revision bill is to loosen the constraints which present Federal taxation imposes on the American economy. The results of these tax reductions and revisions will be a higher level of economic activity, fuller use of our manpower, more intensive and profitable use of our plant and equipment; and with the increases in wages, salaries, profits, consumption, and investment, there will be increases in Federal tax revenues.

Continuing, he emphasized the legislation represented a choice of tax reduction over increased expenditures, noting that increase in expenditures adds to the share of economic activity which is initiated in Government, while—

> The tax reduction road, on the other hand, gets us to a higher level of economic activity—to a bigger, more prosperous, more efficient economy—with a larger and larger share of that enlarged activity initiating in the private sector of the economy—in the decision of individuals to increase and diversify their private consumption and in the decisions of business concerns to increase their productive capacity—to acquire more plant and machines, hire more labor, to expand their inventories—and to diversify and increase the efficiency of their production.

The contemporary dialog.—Unfortunately, a sharp upward trend in domestic spending has followed enactment of the tax reduction legislation in February 1964. With the excise reductions of 1965, and the upsweep in military spending, there was a minimum of discussion on new income tax reductions until Secretary of the Treasury Fowler revived the subject in a speech on December 6, 1966:[2]

> To this end—the maintenance of a strong economy free from repressive taxation—we will want to adopt tax reduction, with emphasis upon rate reduction, as a conscious long-term policy. Only in this way can we avoid fiscal drag and insure that the fiscal dividend payable out of growth can be reinvested in the "growth business" of our economy. Without this conscious determination, our economy can almost unawares be saddled with 1966 tax rate levels and an expanding public sector decade after decade, constantly squeezed by a growing taxload in relation to a proportionately shrinking private sector which must, after all, pay for our defense, our consumer needs, and our public improvements.

At the end of 1966, the Congressional Joint Economic Committee released a study[3] prepared under the direction of Dr. James W. Knowles which pointed to the type of decisions to be faced in order

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[1] Press release, Sept. 16, 1963.

[2] "A Long Term Look at Fiscal Policy," before the Tax Foundation, New York.

[3] "U.S. Economic Growth to 1975: Potentials and Problems," prepared for the Subcommittee on Economic Progress.

to achieve optimum growth over the years ahead. After noting the necessity for policies which would dampen inflationary pressures during the military buildup, the report says:

> Assuming successful resolution of the Vietnam situation in the near future, the type of longer run fiscal policy decisions that would be facing the Nation appear to be more pleasant ones. These may involve primarily choices among alternative methods of tax reform and reduction. Tax reductions, under those conditions of stable or declining defense spending, could both assist in achieving a maximum employment economy and also be possible because of a rapidly rising level of GNP.

In his Economic Report transmitted to the Congress in January 1967, President Johnson in a section entitled "After Vietnam" reported an interagency project of planning for peace in which the "possibilities and priorities for tax reduction" are listed first.

In a speech on April 10, 1967,[4] Secretary Fowler discussed "the longer range outlook for tax rate realinement and reduction," vigorously reaffirming the commitment expressed in his December talk.

While emphasizing the importance of expenditures for training and education, he also emphasized the importance of expenditure control as follows:

> The task is this: As our revenues grow, along with our gross national product, there is going to be a multitude of demands for the extra money. We must decide, calmly, carefully, patently, and skillfully, where it is to go. If we do everything that everybody will want to do—if we appropriate all of it for expenditures which are more desirable than necessary—we will miss the opportunity for a better life, a more secure and happy life, for all of us in the years ahead. This is why the concept of Federal expenditure control is an interrelated part of a sound tax policy for growth.

In a speech on April 20, 1967,[5] Chairman Mills recalled the explicit commitment to a long-range fiscal policy stressing tax reduction in this 1963 release, and stated:

> Great importance should be attached to regular, frequent, and significant reductions in tax rates. Virtually all of the objectives of the good economic society are served thereby. Certainly economic growth is enhanced by tax reduction which reduces the constraints or entrepreneurship, on risktaking, on launching new ventures, and on all sorts of productive effort. Surely the dynamic character of the economy and the efficiency of use of production capability is enhanced by tax rate reduction which moderates the tax advantages or disadvantages of particular groups of taxpayers and thereby reduces tax-induced distortions in the allocation of resources. And beyond doubt, economic freedom is bolstered by general tax reduction which broadens the command of private economic entities over the society's productive resources.

Then, on April 28, 1967,[6] Dr. Duesenberry presented a talk in which

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[4] "The Uses of Tax Policy," before the Kentucky Chamber of Commerce, Louisville.

[5] "Fiscal Policy and the Good Economic Society," before an American Enterprise Institute symposium, Washington.

[6] "Measurement of Fiscal Policy Effects," before an American Statistical Association conference, New York City.

he stated, "Annual tax adjustment should be considered a norm even in an ideal economic environment," and "A series of moderate annual adjustments in tax rates would keep the economy close to the path of steady growth and avoid the necessity for major actions after the economy has lost the momentum of growth or begun a cumulative process of accelerated growth."

Critical decisions ahead.—This dialog provides encouragement to all who are concerned about achieving a less oppressive Federal tax structure. It is welcome and gratifying that top policymakers would be so definitely committed to a policy of tax reduction after peace comes in Vietnam. And it is with no intent to detract one whit from the promise and importance of their expressions to state that the decisions most critical to the effectiveness of tax reduction lie ahead. The questions of size of reductions, of the distribution among taxpayers of the relief to be granted, and of the method or methods to be used, are fraught with controversy.

The critical elements of the postwar program, or the first postwar program, probably will not be known until the executive branch submits its proposals to the Congress, and of course there could be major changes in the course of legislative consideration. In the meantime, the dialog will grow with authorities in and out of the government participating. In this bulletin we present some of the relevant facts and policy options in the three critical areas of decision.

On the *amount of tax reduction*. the basic facts are annual revenue growth of $7 to $9 billion or more in the contemporary era, and the probability that military spending will be cut back $10 to $20 billion over a period of time when the war is over in Vietnam.

In the materials reviewed above, only the Joint Economic Committee report and Dr. Duesenberry's talk provide clues to policy thinking on amount. A model is included in the former which assumes that about one-third of the revenue growth will be used for tax reduction. and two-thirds for increases in expenditures, mostly in the form of transfers and grants-in-aid to State and local governments. Preceding use of the word "moderate," Dr. Duesenberry indicates that annual adjustments in rates "would normally be fairly small."

The Council's program contemplates encumbrance for tax reduction of about $6 billion of annual revenue growth, but with procedures for arresting reductions which would permit a lower average level of actual reductions.

The point to remember here is that exepnditure programs normally will fully absorb revenue growth which is not used for tax reduction.

On the question of *distribution of tax reduction* among taxpayers, it is first relevant to consider the revenue effect of various means of reducing tax liability (based on 1967 estimated income levels):

1. One percentage point reduction in all personnal tax rates—$3.2 billion.
2. $100 increase in exemptions—$3.1 billion.
3. Increase in minimum standard deduction from $300 to $100 to $700 to $100, both with $1,000 ceilings—$1.1 billion.
4. Increase in standard deduction from 10 percent with the $1.000 ceiling to 15 percent with a $1,500 ceiling—$1.6 billion.
5. One percentage point reduction in top corporate rate—$800 million.

As regards individuals, the critical question is how people at various income levels will fare, and specifically, whether the relative steepness of rate graduation will be increased, stay much the same, or be diminished. The Council's program recommends changing the curve of graduation through the middle brackets to a relatively flat line of graduation, i.e., diminish the sharp upsweep in rates to a modest bracket-to-bracket rise.

It should be noted that after the 1964 income tax reductions, the then Secretary of the Treasury Douglas Dillon, stated that the next tax reduction should emphasize relief for low-income people, and a similar statement was made by President Johnson when he signed the excise tax reduction legislation of 1965. However, this objective could be accomplished by increasing the minimum standard deduction, or by other means, while still pursuing a program of rate reform which would provide significantly higher reductions in the middle brackets than in the lower brackets. The relevant facts with regard to the composition of rate reduction follow:

1. The relative degree of progression would be increased if tax rates were cut by a uniform number of percentage points in each bracket. For example, a 5 percentage point cut in all rates would have a revenue effect of $16 billion and provide an average reduction of 32.5 percent in the first four $500 brackets, but only 10 percent in the $22,000 to $26,000 bracket where the present rate is 50 percent, and only 7 percent in the top bracket.
2. However, if there were an across-the-board reduction with the rates above the first four brackets also being reduced by 32.5 percent, the revenue effect would be $20.5 billion.
3. The personal tax cuts recommended in the Council's program would have a revenue effect of $22.7 billion. In other words, the revenue effect of flattening the curve of graduation would add the difference between $20.5 and $22.7 billion, or $2.2 billion, to the cost of a 32.5 percent cut across-the-board.
4. Any across-the-board rate reduction, with about 10 percent added for extra cutting through the middle brackets, will move the tax system toward the goal of a flat line of graduation.

Over the years, the *method or methods of tax reduction* used will have significance for both the amounts of reductions and the distribution of reductions among taxpayers. Methods embodying long-range concepts are likely to result in more tax reduction and also to accomplish more in the way of fundamental rate reform. There are at least four options with regard to methods as follows:

1. A large, one-shot program without implication for subsequent legislation, probably making reductions over more than one budget year.
2. Repetitive annual reductions with policy issues reviewed and decided anew each year.
3. Repetitive annual reductions with the guiding philosophy and perhaps a model for reductions established in the initial legislation.
4. Repetitive annual reductions, prescheduled in legislation which would contemplate a rolling program (review and extension before all reductions are effected), as suggested by the Tax

Council. Such legislation necessarily would provide procedures by which the scheduled reductions could be either speeded up or arrested, and the Council's program also contemplates provision for temporary reversal of reductions as a means for making short-term increases in tax rates.

Taxpayer attitudes on tax rate graduation.—In subsequent publications, we will participate further in the continuing dialog. In this issue, we close with an observation on the taxpayer interest in the moderation of graduation.

It has often been said that the average taxpayer likes the graduated income tax because he has the satisfaction of knowing that others get it worse than he does. This may be so when graduation is pictured as a means of soaking-the-rich. Actually, however, a great many people neither understand nor care about the tax rates paid by the rich, but are much more concerned about how they get hit personally. Just as we have in this country more people who strive to get more education or achieve more on-the-job training to advance themselves, or who just naturally work harder on the job, than in other countries, so do we have more people who are sensitive to the fact that extra effort not only gets them more tax but a higher tax rate. In this dynamic era of wide-open opportunity for all who are willing to make the effort, moderation in the rate of graduation would be a popular public policy.

It is not to be expected that moderation would come about in a redistribution of tax burdens, that is, by decreasing taxes up the income line and increasing them at the bottom. Fortunately, we are on the threshold of an era when the Federal tax burdens of all may be substantially reduced. The policy we suggest is simply that of doing somewhat more than average through the critical brackets where the rates now climb so steeply and unfairly.

The $2 billion-plus cost of flattening the curve of graduation under the Council's program is only about 3½ percent of the current level of revenues from the personal income tax, or about one-quarter of the annual revenue growth. To incorporate this amount of "rate reform" in tax reduction which over the years ahead certainly will be counted in the tens of billions of dollars is not a great deal to ask.

JOHN C. DAVIDSON, *President.*

NEEDED: A LONG-RANGE APPROACH TO FEDERAL TAX POLICY*

BY RESEARCH AND POLICY COMMITTEE, TAX COUNCIL

Historically, the short-term view has dominated in enacting and changing tax rates and burdens. The approach of this report is that tax policy should be fundamentally related to long-term considerations, by planning in advance the pattern of rates for the upcoming years. We believe our society would reap substantial benefits, in greater and more consistent prosperity and in more and better jobs, if this pattern moderated the more restrictive features of the present rate structure. We also believe that, when national security permits, a progressive lowering of the overall burden of Federal taxation relative to national income would provide a better balance in intergovernmental fiscal relations, and better equip the Federal Government to meet future emergencies.

Looking back to the beginning of the income tax in 1913, the prevailing attitude was that rates would never get as high as 10 percent. Yet under the fiscal and emotional pressures of the First World War, the rates topped out at 77 percent just 5 years later. There was a gradual reduction of all rates in the 1920's. Then, in the depth of the 1930's depression, rates on the higher incomes went zooming past 50 percent again. During World War II, this steeply graduated rate pattern was extended through the middle income brackets.

Taxes have a direct and immediate effect on those who pay them and a longer range and indirect effect on economic trends.

It has long been noted that when Federal taxes are increased relatively larger amounts are taken from people and businesses up the income line and, when taxes are decreased, the larger reductions tend to go down the income line. This pattern of action, is often but unfairly attributed to politics alone. The pattern fundamentally derives from the economic view that taxes should be levied with major concern for the impact on immediate spending and consumption. If the economic view were more oriented to long-term growth and prosperity, we should not assume that politics would dictate a frustrating legislative policy.

Although the past has not brought an official move to relate the rate structure to long-term considerations, there has been a great deal of discussion about the economic impact of high rates since the mid-1950's. Especially, concern about the continuous impact of high tax rates on economic progress ran through the official dialog preceding the 1964 tax reductions. Thereafter, increase in domestic expenditures plus the cost of the Vietnam war turned immediate attention to in-

*A report of the Research and Policy Committee of the Tax Council, February 1967.

creasing revenues. Even, however, as the administration has found it necessary to request a temporary tax increase in connection with the fiscal year 1968 budget, there are promising signs for the long pull. In a speech delivered in early December, Secretary of the Treasury Henry H. Fowler was most specific in stating "To this end—the maintenance of a strong economy free from repressive taxation—we will want to adopt tax reduction, with emphasis upon rate reduction, as a conscious long-term policy." [1] Then, President Johnson in January in a section of his Economic Report entitled "After Vietnam" reported an interagency project of planning for peace in which the "possibilities and priorities for tax reduction" is listed first.

Sources of Tax Reduction

Generally in the past, reduction in taxes has been associated with reduction in public spending. There is no history of major reductions, however, except after periods of military emergency. Even though a large part of war expenses always has been deficit-financed, return to a peacetime basis generally has permitted some reduction in tax burdens.

In recent years, another source of tax reduction has come into prominence and been officially recognized; namely, the added revenue which comes from economic growth. It has always been known that public revenues increase as the economy expands but it was not until 1964 that substantial tax reduction was legislated in reliance on this source.

In the contemporary period, a Federal revenue gain of $7 to $9 billion annually is accepted as normal. But this gain can only take place if and when the economy grows strongly. Offhand, it might seem that tax reduction should be held up until it becomes certain that the gain actually has been realized in a particular year, and has not been spent; in other words, is available in the form of a surplus. However, to follow this procedure could be self-defeating for two reasons:

> The first reason is that revenue gain and strong economic growth have an interacting relation; if the growth does not take place, the gain will not be realized; and, if the gain is not used as it accrues, the growth may not take place. This latter situation develops because of what the economists call "fiscal drag." This term means that the Government's tax take is increasing faster than its spending. When the revenue gain is returned to taxpayers or spent as it accrues, fiscal drag will not exist. At a time when the private economy is weak, fiscal drag may prevent recovery to an adequate growth level. Even if the private economy is in good shape when drag develops, the results nevertheless could be to trigger a downward trend. The only safe time to incur fiscal drag is when the private economy is overheated; then it may be quite desirable until a cooling off begins, when a quick reversal in fiscal policy may be in order.
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> The second reason why tax reduction should not await the accumulation of a surplus is the continual pressure on Government from many sources for increased spending. These pressures are so great that it is normal to make commitments for spending to the full level of expected revenues. The danger of fiscal drag may be

[1] "A Long Term Look at Fiscal Policy", by the Honorable Henry H. Fowler, Secretary of the Treasury. Address to the 29th Annual Dinner, Tax Foundation, Inc., Plaza Hotel, New York, Dec. 6, 1966.

used to bolster the case for more spending on various programs just as it may be used as the basis for planning tax reduction in advance. If spending continues to increase year after year so that the Government always is putting as many dollars back into the economy as it is taking out, there will be no danger of fiscal drag—and there will be no opportunity for tax reduction.

First Suggestion

Our first suggestion therefore is that a substantial portion of the anticipated revenue gain be earmarked in advance to finance repetitive tax reductions. We believe these reductions should be oriented to the economics of long-term growth, which is the subject of our third suggestion. Nevertheless, we believe it would be sound government policy to plan tax reduction in advance even if the pattern of reduction were contrary to our thinking.

In theory, the Government may use revenue gain to retire debt, to increase spending or to reduce taxes.

As a practical matter debt retirement can take place only when the Government runs a surplus. This condition may develop when the economy grows very strongly or becomes overheated, but it is an impossible one to plan for on a regular basis. The accumulation of a surplus creates fiscal drag which in turn may be expected to slow down the economy when it is not operating in very high gear.

When it comes to increased spending we know from experience that it is very difficult for the Government to pull back from commitments once made on domestic programs. This means that when revenue gain is once committed for such spending it is most likely that the spending will take place. If, after its commitment, the Government becomes faced with an emergency in which it needs to make other use of the revenue gain, it finds great difficulty in doing so. Thus, when the Government is faced with an emergency situation, such as in Vietnam, for example, it is forced to excessive reliance on increasing the current burden of taxation.

When we turn to tax reduction, however, we find that the Government has much greater freedom of action to meet emergencies. Tax reduction is not sacrosanct, at least to the degree that spending is on domestic programs. It is feasible to preschedule tax reduction out of anticipated revenue gain without final commitment that the reductions will actually and irrevocably take place when scheduled, and our next suggestion is that consideration be given to a plan which would reserve for the Government maximum flexibility in the use of the revenue gain.

Second Suggestion

The plan would schedule annual tax reductions over a number of years ahead. Enactment of such a schedule would automatically allocate revenue gain to support the reductions. If the Government did not become confronted with current need for the revenues involved, these reductions would take place as scheduled. However, unlike commitments for future spending, the tax legislation would provide a procedure for holding up the scheduled reductions when necessary.

Specifically, the legislation would provide for short-term tax adjustments within the schedule of long-term reductions. Mechanics of the

legislation would involve subdividing the annual tax reductions into units, probably two for each year, and providing a procedure by which Congress could accelerate, decelerate, or even temporarily reverse the effectuation of the units of reduction. The procedure for reversal of reductions would provide the means for effecting short-term increases in tax rates.

For example, if such legislation encumbered $6 billion of revenue gain a year, and had been in effect for 2 years, Congress would have available a total of $12 billion in past decreases which could be temporarily reimposed in units of $3 billion. It also could arrest for emergency use an additional $6 billion allocated to the upcoming year; and this procedure could be continued as necessary in succeeding years. The legislation would contemplate a rolling program, i.e., review and re-enactment before all of the prescheduled reductions were affected, so that there would be continuously available units of tax reduction to be speeded up, held back, or temporarily reimposed, as conditions might dictate.

The basic purpose of our suggestion is the establishment of continuing policy of earmarking revenue gain for tax reduction. Nevertheless, the plan outlined would provide maximum flexibility to the Federal Government in adjusting revenues to meet fiscal and economic emergencies.[2] Under the plan, all decreases in tax would be permanent but subject to temporary reversal, while all increases in tax would be temporary but subject to extension.

Because of the flexibility which it would provide to the Government, we believe this plan deserves sympathetic consideration by those who would be inclined to the view that the largest portion or even all of the revenue gain should be used to finance increases in domestic spending. Under the mechanics of the plan, the earmarked revenue gain could in any year be diverted to the financing of more domestic spending. In practical operation, the procedure proposed would mean that, whenever the President in January submitted an expenditure budget which would use more than the unencumbered portion of the revenue gain, he would ask the Congress to postpone one or both units of the upcoming scheduled reduction as judgment indicated would be necessary to prevent inflation while avoiding fiscal drag. It is true that this procedure would exert a discipline on increased spending for domestic purposes by calculating its cost in terms of tax reduction dollars immediately foregone, but this would seem to us to be a desirable feature of public budget-making procedures.

The ultimate question each year of course would be whether the public good would be better served by letting the unit or units of tax reduction go into effect as scheduled, or by spending the revenue gain involved on domestic programs.

Third Suggestion

Inevitably, the most controversial aspect of a plan for earmarking revenue gain for tax reduction is the composition of the prescheduled reductions. As we have indicated, we believe that such a plan would

[2] This report is prepared in the midst of a controversy over whether the administration should have requested tax rate increases last year, and who stood for or against tax increases at that time. In our view, it would be much easier to get a decision on the timing of short-term tax changes than on the composition of those changes. The plan we suggest would put the policy issue of composition on a long-term basis, leaving only the question of timing to be decided when the Government is confronted with an emergency.

serve the public good whatever kind of tax reduction is provided. Nevertheless, we are strongly of the view that reform and reduction of what we consider excessive tax rates is a matter of major importance in its own right, and our third suggestion is that the most serious consideration be given to establishing goals for tax rate moderation.

In this initial report, we are not attempting to document in depth the case for the kind of rate reform and reduction which we advocate. Nevertheless, we believe that there are four basic benchmarks which deserve consideration as guides to long-term tax policy. These are:

First, it is unfair and uneconomic to impose a sharply ascending scale of tax rates on the more ambitious, energetic, and successful members of any given generation. This is the pattern of existing rates, and it is unfair because it is contrary to the accepted norm for compensation, namely, that whoever works longer and harder than the average deserves extra compensation. Graduation penalizes those who are rewarded for extra effort by both private and public employers. The result is uneconomic, we believe, because it arbitrarily reduces the amount of new capital in the most dynamic hands.

Second, the greater the amount of capital available to any society, the greater will be its economic development and the higher its living standards. It is this factor more than any other which tends to be overlooked when tax policy is viewed from the short term. Taking a broader and longer view, whatever limits capital limits economic growth and the creation of new and better jobs. Looking abroad, we always recognize the insatiable need for capital, but there is a tendency to overlook the application of this statement at home. It is not suggested here that tax policy should favor capital formation over current consumption, but there certainly is a case for getting much closer to neutrality as between the two than would be indicated by much of the economic literature of recent decades.

Third, both excessive tax rates, and an excessive burden of taxation overall at the Federal level in relation to national income, inevitably adversely affect tax decisions at the State and local levels. It is evident that the fundamental corrective is moderation of both the rates and the burden at the Federal level.

Fourth, the same excessive tax rates, and the same excessive burden of taxation overall, inevitably would make it most difficult for the Federal Government to meet a really major new national emergency. A significantly lower base of both rates and overall burden would put the Nation in the position of being fiscally prepared to meet whatever emergencies may come hereafter.

Specifies of Rate Reform and Reduction

Because of the magnitude of the annual revenue gain, it is feasible to plan for major reform in the excessive tax rates while still providing very substantial reduction in burdens for all taxpayers.

In the initial plan, we suggest two major goals, first, flattening the curve of graduation through the middle brackets of the personal income tax and, second, reducing the top rate of corporate tax to the level prevailing between World War II and the Korean war. We

include with these goals a reduction of 29 to 36 percent in the lowest four brackets of the personal tax.

Calculated at estimated income levels for 1967, our plan would produce some $30 billion in tax savings when completely effectuated. While we believe that legislation should schedule the reductions over the 5-year period, initially encumbering about $6 billion of the revenue gain each year, there inevitably would be some postponements. If only two $3 billion units of reductions were postponed for only 1 year, for example, the average annual use of revenue gain would be only $5 billion. As we have indicated earlier, encumbrance of revenue gain under such a plan would enhance the government's flexibility to meet emergencies as they develop.

The details of the plan are set forth in table I and illustrated on chart I.

Beginning at 9 percent, as compared with the present 14 percent, in the first $500 bracket, the new rate scale would move up to a top of 57 percent, as compared with the present 70 percent in the $100,000 and over bracket. In flattening the curve of graduation, the greatest reduction would come in the middle brackets, with the present 50 percent rate in the $22,000 to 26,000 racket for single returns, for example, coming down to 25 percent.

Percentagewise, as shown in the fourth column of table I, the maximum reduction in the middle brackets would be 53 percent, as compared with 36 percent in the first bracket and 19 percent in the top bracket.

Tax savings by taxable brackets are shown in table II. $21.3 billion or approximately 94 percent of the total savings of $22.7 billion calculated at 1967 income levels would accrue in the brackets where the rates are now up to 50 percent.

TABLE I.—*Personal income tax rate structure*

Taxable income bracket (single returns [1])	Present	Suggested	Percent reduction
0 to $500	14	9	36
$500 to $1,000	15	10	33
$1,000 to $1,500	16	11	31
$1,500 to $2,000	17	12	29
$2,000 to $4,000	19	13	32
$4,000 to $6,000	22	14	36
$6,000 to $8,000	25	15	40
$8,000 to $10,000	28	16	43
$10,000 to $12,000	32	17	47
$12,000 to $14,000	36	18	50
$14,000 to $16,000	39	19	51
$16,000 to $18,000	42	20	52
$18,000 to $20,000	45	21	53
$20,000 to $22,000	48	23	52
$22,000 to $26,000	50	25	50
$26,000 to $32,000	53	27	49
$32,000 to $38,000	55	29	47
$38,000 to $44,000	58	31	47
$44,000 to $50,000	60	34	43
$50,000 to $60,000	62	37	40
$60,000 to $70,000	64	40	38
$70,000 to $80,000	66	44	33
$80,000 to $90,000	68	48	29
$90,000 to $100,000	69	52	25
$100,000 and over	70	57	19

[1] Brackets are double the given range for joint returns.

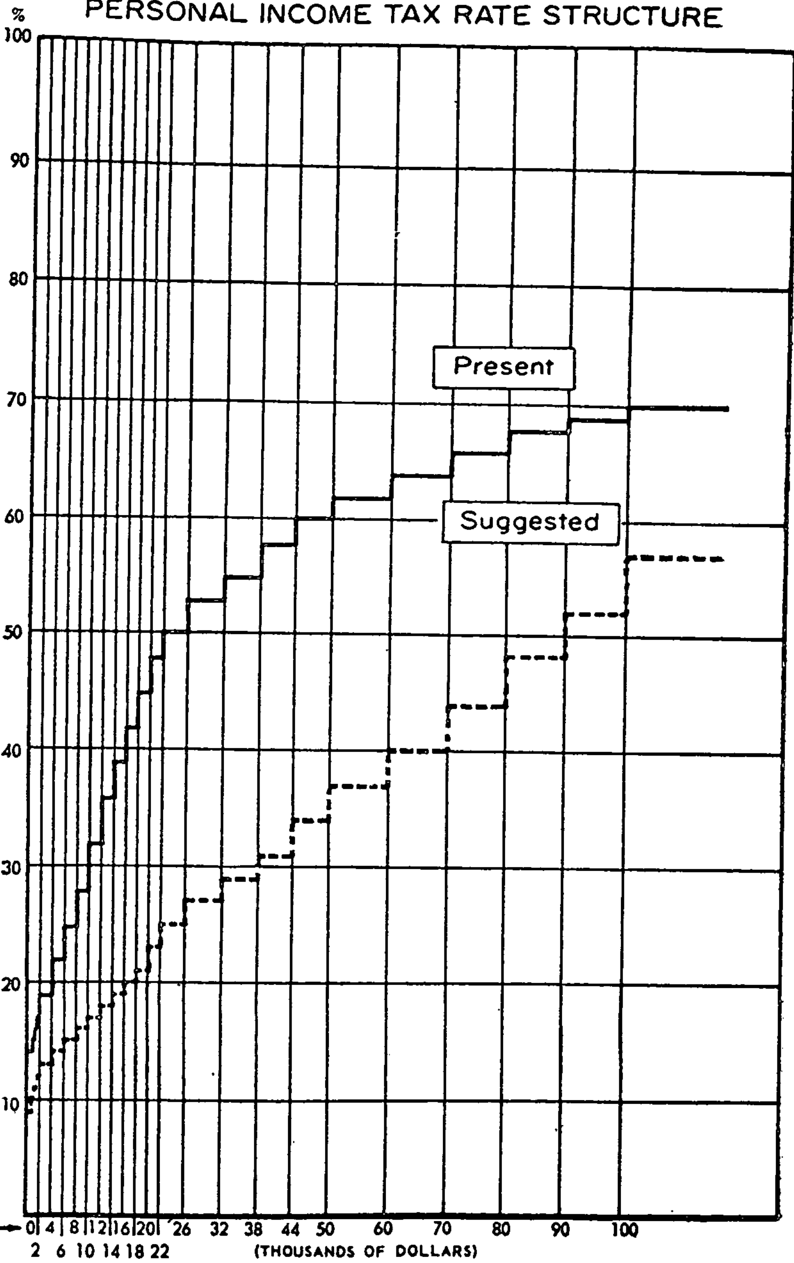


Chart I
PERSONAL INCOME TAX RATE STRUCTURE
%
100
90
80
70
60
50
40
30
20
10
Present
Suggested
TAXABLE
INCOME
BRACKET
0 4 8 12 16 20 26 32 38 44 50 60 70 80 90 100
2 6 10 14 18 22
(THOUSANDS OF DOLLARS)

TABLE II.—*Personal income tax savings by tax brackets*

Taxable income bracket (single returns [1])	Present rates	Suggested rates	Tax savings	
			Amount (millions)	Percent of total
0 to $500	14	9	$2,359	10.4
$500 to $1,000	15	10	2,052	0.9
$1,000 to $1,500	16	11	1,920	8.5
$1,500 to $2,000	17	12	1,642	7.2
$2,000 to $4,000	19	13	4,839	21.3
$4,000 to $6,000	22	14	2,449	10.8
$6,000 to $8,000	25	15	1,331	5.9
$8,000 to $10,000	28	16	928	4.1
$10,000 to $12,000	32	17	787	3.4
$12,000 to $14,000	36	18	676	3.0
$14,000 to $16,000	39	19	562	2.5
$16,000 to $18,000	42	20	492	2.2
$18,000 to $20,000	45	21	443	2.0
$20,000 to $22,000	48	23	351	1.5
$22,000 to $26,000	50	25	502	2.2
$26,000 to $32,000	53	27	438	2.0
$32,000 to $38,000	55	29	270	1.2
$38,000 to $44,000	58	31	170	.7
$44,000 to $50,000	60	34	112	.5
$50,000 to $60,000	62	37	115	.5
$60 000 to $70 000	64	40	72	.3
$70,000 to $80 000	66	44	45	.2
$80 000 to $90 000	68	48	19	.1
$90,000 to $100,000	69	52	18	.1
$100,000 and over	70	57	97	.4
Total			22,699	100.0

Tax savings cumulated

Taxable income range	Cumulative savings (millions)	Cumulative percent
0 to $2,000	$7,973	35.1
$4,000	12,812	56.4
$10,000	17,520	77.2
$26,000	21,333	94.0
$50,000	22,323	98.3
$100,000 and over	22,699	100.0

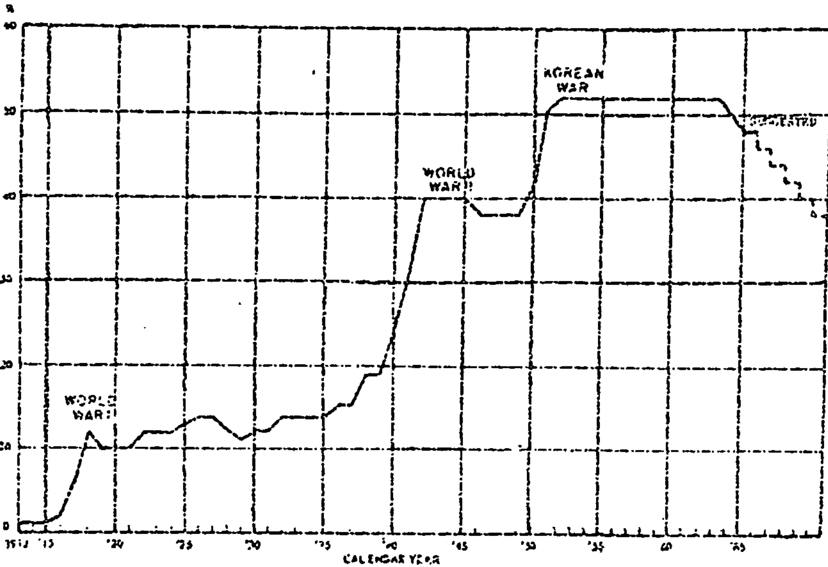
[1] And ½ the combined brackets of joint returns.

Chart 2 shows that the history of corporate taxation is one of little if any moderation of the rates of regular tax between wars. There was a modest reduction in the top rate, from 40 to 38 percent, at the end of World War II, but the top was moved up sharply to 52 percent in the Korean war and there was no reduction thereafter until 1964. As indicated at the right side of the chart, our suggestion is that the initial plan contemplate reducing the present 48 percent rate to the pre-Korean 38 percent in five annual steps of two percentage points each. This would be a reduction of 20 percent. Calculated at corporate income levels anticipated for 1967, the tax savings would reach $8 billion when all reductions had been effectuated.

CONCLUSION

In this report, we have suggested: first, that a substantial portion of the yearly revenue gain ($7 to $9 billion) be earmarked in advance to finance repetitive tax reductions; second, that the earmarking be

CHART 2
CORPORATE INCOME TAX RATES*



* Top rates of tax excluding excess profit taxes

done by scheduling reductions over a number of years ahead with the legislation providing a procedure by which Congress could accelerate, decelerate, or even temporarily reverse all or part of a year's reduction within the long-range plan; and third, that the legislation establish goals for moderation of excessive tax rates, using as guides four basic benchmarks.

To give effect to the third suggestion, we have proposed an initial plan which would, first, flatten the curve of graduation through the middle brackets of the personal tax and second, reduce the top rate of corporate tax to the level which existed between World War II and the Korean war.

We are convinced that the kind of legislative program we propose would be of great benefit to our national economy, and put the Government in much better position to meet future emergencies. With the opportunities for tax reduction which lie ahead, and the interest of every citizen in a stronger economy, the need for more research seems evident. We believe that concerned people and groups will agree it is necessary to learn all we can about the relation of taxes to economic progress, and to do all we can with the knowledge we have or may acquire.

FISCAL POLICY AND THE GOOD ECONOMIC SOCIETY*

BY Representative WILBUR D. MILLS (D., Ark.)

In the last several years, the significance of fiscal policy for the performance of the American economy has received an unusual amount of attention in the press, in public forums, in the academic community, and in the business world. Very likely this emphasis is attributable to a view which has gained wide currency to the effect that the revenue productivity of the Federal tax system tends to increase so rapidly—withdrawing so much from the income flow of the Nation—that private spending will be unduly constrained if tax rates are not periodically reduced or if public spending is not increased to fill the gap. The fiscal developments of 1962, 1964, and 1965 seem to have established the validity of the view; the changes in the tax structure apparently were associated with a marked increase in momentum in economic activity until recent months. This happy congruence of appealing theory and a pleasing turn of events has resulted, as is so often the case, in a possibly greater enthusiasm for fiscal manipulation than the limited experience which it might warrant, but this is of much less consequence than the fact that we seem to be focusing on fiscal arithmetic rather than on the real aims and significance of fiscal policy in the first half of this decade.

Any public policy can be appraised only in the light of its objectives. There need not, of course, be a consenses concerning the aims of a public policy, and the rating it gets, therefore, may vary not only because of differences in viewpoint about how it has performed but as well because of disagreements about what it was supposed to do. In the following remarks, then, you will find one system of preferences which, hopefully, will prove persuasive.

In very general terms, fiscal policy, just as any other element of political economy, should seek to contribute to the attainment of the good economic society. A good economic society is highly progressive; its members seek to advance their well being and this desire is a strong motive force in their personal lives and is reflected in the performance of the economy as a whole. The progressive spirit leads them to venture, to look for the new, to seek out challenges to do things better—better than they've been done before and better than anyone else is doing them now. It is fashionable in some quarters these days to speak derisively about building better mousetraps and to decry the gadgetry in our lives, as if these individually inconsequential items were in competition with culturally grander things for our interest and energy. But this isn't the case and ignores the fact that our technical

*Address of Congressman Wilbur D. Mills before the American Enterprise Institute Symposium on Fiscal Policy and Business Capital Formation, Washington, D.C., Apr. 20, 1967.

progress consists of the aggregation of all such little bits and pieces of better things and better ways of doing as well as the more glamorous and impressive advances.

A society that gives ample play to this impulse is a dynamic one. It is also highly diverse. Because it's dynamic, it's subject to frequent shock, but because of its diversity, relatively few of the adjustments thereto involve widespread or prolonged dislocations. Indeed, the Nation's economic history offers repeated evidence of the fact when the economy is allowed to adjust of itself to such disturbances it does so relatively quickly and smoothly.

The good economic society is efficient. It allocates the various elements of its production capability to those uses in which they will contribute most to total output and to the well-being of its people. It quickly recognizes changes in costs and in benefits and facilitates rather than impedes the rearrangement of production activity in response to those changes.

The good economic society is busy and fully employed. It avoids prolonged, involuntary unemployment of large numbers of its labor force, or their prolonged employment in submarginal uses. It recognizes, however, that the rate of use of labor, capital, and other agencies of production cannot be absolutely unchanging in a dynamic environment, and is prepared, therefore, to accept moderate deviations from "full employment" for short periods of time.

The good economic society grows. It increases its capabilities for satisfying the material aspirations of its members, while accommodating their desires for diversity and change.

The good economic society is fair and humane. It seeks to make the benefits of its advances available to all of its members by making sure that none of them are debarred from being or becoming productive participants in its activities. It recognizes differences among its members in their ability to contribute and seeks to moderate rather than to enhance these disparities, not by constraining the more productive but by increasing the productivity of the less fortunate. But where this is not feasible, the good economic society is not indifferent to deprivation. It mobilizes its resources to discover and apply enduring remedies and avoids relying on ad hoc reliefs.

Finally, a good economic society relies on its members to provide the impetus and the means for achieving these goals. It recognizes that in our highly complex economic, political, and social environment, individuals will frequently encounter problems with which they are unable to cope unaided; there is, in other words, a wide array of problems with which society as a whole must deal. But the good economic society is careful to limit its assumption of responsibility to concerns of this character and seeks always to reserve to private economic entities—individuals, households, companies—the maximum possible scope for decision-making, for initiating activity. This is the essence of economic freedom in our world today. And maximizing economic freedom is a major objective of the good society.

How may fiscal policy contribute to attaining the goals of the good economic society? The basic economic facts of life that come to bear here are (1) that every Government purchase involves limiting the availability of production capability for carrying out the plans and

meeting the demands of private economic entities and that (2) virtually every Government levy impacts on the taxpayer's choices among economic alternatives.

The first of these facts accounts for the traditional liberal concern for limiting governmental programs. This is no doctrinaire indictment of Government spending. On the contrary, as the society grows and becomes both more complex and more affluent, the extent and scope of demands for publicly afforded services must be expected to increase as well. But taking a realistic view of the likely course of Government activity doesn't justify indifference to the perpetuation of programs that either have proved to be invalid or have outlived their former usefulness. Nor does it lead to ready acceptance of the ad hoc addition of new programs, often overly ambitious and impractical, no matter how glamorously named nor how worthy their objective. Nor, moreover, does it require tolerance for ill-conceived experiments which could pass a rudimentary cost-benefit test only if the benefits are measured in such ambiguous terms as "prestige." Instead, this view calls for continual reevaluation of existing expenditure programs in the light of rigorous, objective measurement of the benefits they convey and the costs they impose and the requirement that any proposed new program meet the same tests. In fact, all proposals for new expenditure programs should be received with a constructive skepticism; we should start with the assumption that the production capability to be allocated to the program would be better left available to meet demands arising in the private sector of the economy and require the program's proponents to persuade us otherwise.

There are, of course, those who are disappointed because Government expenditures haven't increased more rapidly, who claim the public sector is "starved," and who assert that great public needs go unmet. It should be clear, however, that such assertions are not objective observations, but expressions of preferences. Moreover, the recent and prospective rates of gain in the magnitude of Government expenditures belie the notion of an underprivileged public sector. Between 1960 and 1966, Federal expenditures in the national income accounts increased by 53 percent. In fact, during these years Federal nondefense purchases of goods and services increased twice as rapidly—96 and one-half percent—as gross national porduct less Federal purchases which increased by 47 percent. And of all the major sectors of the economy, none has increased so rapidly in this period as State and local government spending which expanded by almost two-thirds. Surely these facts should give one pause about some recent, bizarre proposals concerning the fiscal relationships of the Federal and State and local governments.

Fiscal policy for the good economic society will place great emphasis on the manner in which the revenues required to defray government expenses are raised. The tax structure will be submitted to frequent reappraisal to determine whether its burdens are fairly distributed and whether it contributes to moderation of extremes in the distribution of income and wealth. Continuing efforts will be made to identify and to eliminate those elements or features of the revenue system which afford preferential treatment to some taxpayers while discriminating against others. And the same healthy skepticism with which proposals

for new government spending programs are received should greet proposals for new tax differentials.

Great importance should be attached to regular, frequent, and significant reductions in tax rates. Virtually all of the objectives of the good economic society are served thereby. Certainly economic growth is enhanced by tax reduction which reduces the constraints on entrepreneurship, on risktaking, on launching new ventures, and on all sorts of productive effort. Surely the dynamic character of the economy and the efficiency of use of production capability is enhanced by tax rate reduction which moderates the tax advantages or disadvantages of particular groups of taxpayers and thereby reduces tax-induced distortion in the allocation of resources. And beyond doubt, economic freedom is bolstered by general tax reduction which broadens the command of private economic entities over the society's productive resources.

If this view of the good economic society and the fiscal policy which is appropriate thereto is appealing, one can only regret the circumstances which are deemed to forefend a long-range program of periodic tax reduction. Our attention has been called over and over again of late to the growth in our tax system's revenue productivity which accompanies the growth of the economy. There may be competing claimants for this potential increment in revenues, but if the goals presented in this discussion are to be sought, tax reduction should be the preferred course.

A few years ago, it appeared that the Nation was firmly committed to this course. Taxation developments in 1962 made some constructive changes in the revenue structure, and the Revenue Act of 1964 and the excise reductions legislated in 1965 seemed to indicate that the Nation had made a commitment to a long-range fiscal policy stressing tax reduction and curbs on the growth of Federal expenditures. Indeed, this was made explicitly clear, as stated in my press release of September 16, 1963:

> The purpose of this tax reduction and revision bill is to loosen the constraint which present Federal taxation imposes on the American economy. The results of these tax reductions and revisions will be a higher level of economic activity, fuller use of our manpower, more intensive and profitable use of our plant and equipment; and with the increases in wages, salaries, profits, consumption, and investment, there will be increases in Federal tax revenues. Increases in economic activity, in the use of our resources, in personal and business incomes, and in Federal revenues might be also realized if, instead of reducing taxes, the Congress and the administration increased expenditures of Government. In other words, there are two roads the Government could follow toward a larger, more prosperous economy—the tax reduction road or the Government expenditure increase road. There is a difference—a vitally important difference—between them. The increase in Government expenditure road gets us to a higher level of economic activity with larger and larger shares of that activity initiating in Government—with more labor and capital being used directly by the Government in its activities and with more labor and capital in the private sector of the economy being used to pro-

duce goods and services on Government orders. The tax reduction road, on the other hand, gets us to a higher level of economic activity—to a bigger, more prosperous, more efficient economy—with a larger and larger share of that enlarged activity initiating in the private sector of the economy—in the decision of individuals to increase and diversify their private consumption and in the decisions of business concerns to increase their productive capacity—to acquire more plant and machines, to hire more labor, to expand their inventories—and to diversify and increase the efficiency of their production.

Section I of the bill is a firm, positive assertion of the preference of the United States for the tax reduction road to a bigger, more progressive economy. When we, as a nation, choose this road we are at the same time rejecting the other road, and we want it understood that we do not intend to try to go along both roads at the same time.

The further meaning of section I of the bill is that no Government activity is to depend for its justification on the amount it contributes to the total spending of the economy, because we prefer to reduce taxes and allow individuals and business concerns in their own right to make that contribution. On the contrary, any and all activities of the Government have to be justified on their importance in serving other essential goals of the Nation. There is no further justification for an indifferent attitude toward wasteful, inefficient Government activities merely because they incidentally give employment—tax reduction will also create job opportunities and in lines of activity which better satisfy the character and demands of the people for an enriched life. There is no more justification for halfhearted efforts or outright failure to eliminate Government programs that have outlived their usefulness just because they also contribute to the total spending stream of the economy—that contribution will be better realized by increasing the purchasing power of consumers and investors through tax reduction. Finally, there is no further occasion for using the additional revenues which will be generated by the expansion of the economy as a result of tax reduction and revision to finance additional Government expenditures, solely because those additional expenditures might add further to expansion of economic activity. If such additional expansion is desired or needed, tax reduction will achieve it just as surely and through vigorous and progressive forces of the private sectors of the economy.

For a brief period after the enactment of the Revenue Act of 1964, the pace of expansion of Federal expenditures did indeed appear to have moderated, but only briefly. The increase of military efforts in Vietnam, of course, accounts for a significant part of the subsequent acceleration of expansion of Federal outlays, but two-thirds of the $28.3 billion increase in Federal expenditures from calendar 1963 through 1966—as measured in the national income accounts—is accounted for by nondefense spending. Moreover, as projected in the January 1967 budget message, over half of the proposed $37 billion

increase in outlays from fiscal 1966 through fiscal 1968 is to be in nondefense programs.

It is, of course, impossible to turn back the clock and one must, therefore, acknowledge that it will be difficult indeed to bring this rapid acceleration of public spending under control. But unless we are prepared to forgo the course of tax reduction for an indefinite period into the future, we should at the least attempt to achieve a pause in the current enlargement of Federal spending.

This discussion has focused on the broad, long-term objectives of fiscal policy, and little has been said about using fiscal policy, or more specifically tax policy, to offset short-term fluctuations in the rate of expansion of total economic activity. The emphasis in the past year and a quarter has been on tax changes for shortrun stabilization objectives. Questions can certainly be raised as to whether this has been a very happy chapter in the Nation's fiscal history. The request for the suspension of the investment credit and accelerated depreciation last fall and for their reinstatement this spring has been a fiscal experience from which, hopefully, it has been learned that taxes should not be raised and lowered from season to season like the hemlines of women's skirts and dresses. It is also to be hoped that those who have so enthusiastically advocated frequent, short-term tax rate changes have been sobered by the turn in the economic indicators and the question as to whether they have properly discerned the major tendencies in the economy. In my view it is questionable whether the mechanical application of fiscal arithmetic contributes to good public finance.

Fiscal policy has an important assignment, but in recent years its press agents have invested it with more power to determine the size, shape, and character of the economy than it has or should have. Let us hope that fiscal policy will soon be refocused on contributing to the attainment of the good economic society.