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Exhibit D

# **Tax assignment in federal countries**

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## I. Introduction

In President Reagan's budget proposal for fiscal year 1983, a call was made for a major change in the U.S. federal system. The proposed change included a switch in responsibilities for certain expenditure programs between state governments and federal governments. The exchange would give the federal government full responsibility for medical care for the poor (Medicaid), and the states would take over welfare (aid to families with dependent children) and food stamps. In addition, the proposal would modify substantially the pattern of federal aid to state governments, with the federal government giving responsibility for a large number of grant programs to the states (over 40, including transportation and other categorical programs), most of which would be paid for initially by a special trust fund financed through federal revenues. After several years the trust fund would be eliminated and states would assume responsibility for financing many of these programs on their own. Behind these Reagan proposals is not only a desire for a shift from federal to state financing of expenditures, but a desire to lower public spending generally.

The Reagan proposals make this a timely opportunity for one to reflect broadly about government finance in the United States. This paper is primarily descriptive, involving some detail about U.S. federal, state and local tax systems. Of course, any descriptive paper would not be complete without some suggestions concerning public policy. The normative theory which serves as the basis for such suggestions comes from the usual public finance framework discussed previously in this volume. The emphasis in this paper is on economic efficiency, as it relates to the choice of tax instruments and the level of government which can best utilize that instrument. Within an economy such as that of the United States, with multiple jurisdictions and multiple levels of government, any efficiency analysis is difficult at best, because of the externalities created when individual governments' actions affect individuals residing in neighboring jurisdictions, or when these actions indirectly affect the mobility of individuals and other factors of production. This is particularly true in the U.S. context in part because of the large and diverse number of jurisdictions and in part because of the mobility of the population. As a consequence, the theory of an efficient allocation of individuals among local jurisdictions has received substantial attention in the economics literature, and will be relied on here.

The descriptive portion of the paper begins with a look at the growth of U.S. government, concentrating on the forms of revenue utilized to finance that growth. Because of the diversity of local jurisdictions, the locational resource implications associated with the choice of various tax instruments are particularly important and receive special treatment. Finally, I look with some care at the growth of federal and state grants-in-aid programs, and evaluate some of the suggested reforms.

## II. The Financing of the U.S. Federal Systems - Background

In designing the federalist system, it is natural to ask what are the appropriate items of public expenditure and what levels of government are most suitable for providing those services. Separate, but not totally distinct from these expenditure issues are the distributive and allocative

concerns of the revenue system. As a result, there is no reason to expect that the level of expenditures and 'own' revenues should be equal for all governments. Of course, the difference between own revenues and expenditures (current expenditures, at least) is due to federal and/or state grants-in-aid. Prior to World War II federal grants were relatively low, making state and local budget balance from own funds a reasonable approximation. However, after World War II the growth in grants altered this relationship substantially.

Unlike those of many other countries, however, U.S. grant-in-aid programs have been almost entirely conditional in nature, with specific programs restricting spending choices to some extent. For example, in 1981 (January) there were 534 federal categorical grants-in-aid programs available to state and local governments (see ACIR, 1982a, Table 2). The one exception is the relatively recent general revenue sharing program, which gives federal aid to state and local governments with essentially no strings attached. Of course, there have been a number of changes over time in not only the level of grants, but also their form, reflecting differences in tastes for the role that governments ought to play in administering programs. With restrictive categorical grants, both the donor and the recipient play an active role in the choice of type of service. With general revenue sharing the grantor's role is minimized. Thus, recent proposals to move to a more expansive form of revenue sharing have implications for service administration, since they tend to break the ties between the financing of the donor and the spending of the recipient government.

To begin the empirical discussion one can examine the growth of spending in Table 9.1. During this century, total U.S. government spending as a proportion of GNP has generally risen. How one allocates the relative growth among sectors depends heavily on how one treats grants. With grants included as federal spending and excluded as state and local spending, the greatest growth appears to be at the federal level. With grants attached to the recipient levels of government, as in the second half of the table, the pattern is less clear. The table also makes it clear that grants-in-aid do make up a sizeable portion of state-local aggregate revenues.

Now consider changes in the composition of the U.S. tax system. Over the past thirty to forty years the tax system has changed substantially both in terms of the form of taxes used and the level of government utilizing those taxes. As Table 9.2 illustrates, the personal income tax has grown as a source of financing, with growth taking place at both the state and the federal level. Of course most of this growth occurred by 1944 at which time the federal tax was well developed. Perhaps the most distinctive trend in federal financing has been the very rapid increase in the use of payroll taxes kept in a trust fund to pay for the social security system. In 1950 payroll taxes amounted to only 10.8 percent of total federal revenues, but this percentage has increased from 23.4 percent in 1970 and to 30.4 percent in 1981 (see U.S. Bureau of the Census, 1981; Historical Statistics, 1975). If current trends continue the payroll tax will supplant the personal income tax as the largest single revenue source in the United States.

At the state level reliance on general sales taxes and personal income taxes has increased over time. Corporate income taxes have grown as well, although somewhat less rapidly. All of the rates of growth shown in Table 9.2 are somewhat misleading, however, because they mask the tremendous diversity in the use of tax instruments by state governments. Most, but not all, states use a sales tax and corporate and personal income taxes, but they vary substantially both in form and in their level of rates.

Finally, the property tax has maintained its role as the primary source of local revenue. However, its dominance has diminished somewhat as user charges and to some extent local sales and income taxes have grown. Once

Table 9.1

## GROWTH OF FEDERAL, STATE AND LOCAL EXPENDITURES

Government Expenditures as a Percentage of GNP					
Calendar Year	Total	Federal (Including Grants)	State & Local (Excluding Grants)	Federal (Excluding Grants)	State & Local (Including Grants)
1929	10.0	2.5	7.4	-	-
1934	19.8	9.8	10.0	8.2	11.5
1938	19.8	10.1	9.6	9.2	10.6
1944	49.0	45.4	3.6	44.9	4.0
1949	23.0	16.0	7.0	15.2	7.8
1954	26.5	19.1	7.4	18.2	8.2
1959	26.9	18.7	8.2	17.2	9.2
1964	27.7	18.6	9.1	16.9	10.7
1969	30.5	20.1	10.4	17.8	12.6
1974	32.4	21.2	11.2	17.8	14.3
1975	34.8	23.3	11.5	19.5	15.0
1976	33.6	22.7	10.9	18.8	14.7
1977	33.0	22.4	10.6	18.5	14.0
1978	32.5	21.9	10.6	17.8	13.9
1979	31.2	21.1	10.2	17.8	13.5
1980	33.1	22.9	10.1	19.6	13.5
1981(est)	33.4	23.4	10.0	20.4	13.0

Source: Calkins and Shannon (1982); Tax Foundation, Inc. (1979); U.S. Bureau of the Census (1967) and (1969, Table 4).



Table 9.2  
EVOLUTION OF THE U.S. TAX SYSTEM

Tax	Fiscal 1902	Fiscal 1922	Fiscal 1932	Fiscal 1938	Fiscal 1944	Fiscal 1950	Fiscal 1960	1970 -71	1979 -80
A. FEDERAL GOVERNMENT Percentage of Revenue from Own Sources <sup>(a)</sup>									
Individual Income	-	45.9	15.9	18.3	39.5	37.3	41.7	43.4	43.8
Corporation Income	-		23.5	19.1	29.5	24.9	22.0	13.5	11.6
Sales, Gross Receipts, and Customs	74.6	27.3	28.8	28.9	9.5	18.6	12.9	9.8	5.8
Payroll <sup>(b)</sup>	-	-	-	5.5	2.4	5.0	10.9	21.1	25.0
Other <sup>(c)</sup>	25.4	26.8	31.7	28.1	19.0	14.2	12.6	12.3	13.8
Total Federal	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Amount (\$ million)									
Total Federal	653	4,221	2,542	6,982	49,923	42,168	97,744	198,796	556,706
B. STATE GOVERNMENTS Percentage of Revenue from Own Sources <sup>(d)</sup>									
General Sales and Use Receipts <sup>(e)</sup>	13.8	16.0	12.7	22.0	24.7	28.7	33.0	40.9	44.4
Individual Income	-	3.8	3.4	6.2	6.9	8.0	10.6	16.5	21.8
Corporation Income	-	5.1	3.7	4.7	9.7	6.5	5.7	5.5	7.8
Motor Fuel, Alcoholic Beverages, Tobacco Products	-	1.2	25.3	28.7	24.2	26.4	23.6	17.3	9.4
Gross Receipts and Other Taxes <sup>(f)</sup>	86.2	60.4	39.4	26.6	23.7	20.2	18.5	14.3	13.1
Motor Vehicle and Operators' Licenses	-	13.5	15.5	10.2	8.6	8.4	7.5	4.8	3.1
Liquor Store Revenues <sup>(g)</sup>	0.0	-	-	1.6	2.2	1.7	1.1	0.7	0.3
Total State	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Amount (\$ million)									
Total State	181	2,128	2,156	3,518	4,586	8,995	20,839	61,709	169,824

Table 9.2 (cont'd)

## EVOLUTION OF THE U.S. TAX SYSTEM

Tax	Fiscal 1902	Fiscal 1922	Fiscal 1932	Fiscal 1938	Fiscal 1944	Fiscal 1950	Fiscal 1960	1970 -71	1979 -80
C. LOCAL GOVERNMENTS									
Percentage of Revenue from Own Sources (d)(h)									
Property	80.2	86.1	86.2	85.0	76.2	74.9	70.3	65.4	54.7
Sales and Gross Receipts	-	0.6	0.5	2.4	2.4	5.1	6.0	6.5	10.1
Income (i)	-	-	-	-	0.5	0.7	1.1	3.1	4.2
User Charges and Miscellaneous	12.1	13.8	12.5	10.0	13.4	17.0	21.5	25.4	36.7
Utility (h)	- 2.6	- 2.7	- 1.1	- 0.6	4.3	- 2.1	- 2.0	- 2.5	- 8.5
Other Revenue from Own Sources (j)	10.3	2.2	1.8	3.2	3.3	4.3	3.2	2.1	2.8
Intergovernmental from States	6.7	9.0	16.6	30.7	32.2	44.8	42.4	55.4	67.8
Intergovernmental from Federal	0.5	0.3	0.2	3.4	0.5	2.2	2.6	6.0	17.6
Total Local	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Amount (\$ million)									
Total Local	778	3,452	4,824	4,939	5,720	9,403	22,479	56,131	119,934

- Notes: (a) Includes general revenue and old-age and survivors insurance  
 (b) Old-age and survivors insurance  
 (c) Includes gift and death taxes, other taxes, and charges and miscellaneous general revenue  
 (d) Excludes insurance trust revenue and includes net liquor store revenues  
 (e) Includes general sales and charges and miscellaneous general revenues  
 (f) Includes other gross receipts, property taxes, death and gift taxes and all other taxes  
 (g) Liquor store revenues minus expenditures  
 (h) Includes net utility revenues  
 (i) Consists of individual and corporation taxation  
 (j) Includes gift and death taxes, all other taxes, and net liquor store revenues.

Sources: U.S. Bureau of the Census, Historical Statistics (1975, Part 1, Tables Y 710-35, Y 567-89, Y 798-816);  
Government Finances, various years, Table 3.

again, there is great diversity in local revenue sources underlying these averages. Local sales and income taxes are used extensively in only a few states, and reliance on user charges varies substantially both within and among states.

With this background we can look more carefully at the role of grants in the federal system. As shown in Table 9.3, the use of grants has grown very rapidly throughout the twentieth century, and especially after World War II. For example, federal grants to states and localities have increased to the point where they make up about 15 percent of total federal expenditures (Oates, 1980, p. 337). States, on the other hand, receive about one quarter of their total revenues in the form of federal aid. States, of course, have programs of grants-in-aid of their own, a portion of which is passed through from the federal government, and another portion that originates at the state level. Overall, local governments receive about 40 percent of their total revenues in the form of state and federal aid (Oates, 1980, p. 338).

Economic theory suggests that grants are suitable devices for treating externalities of various kinds and for redistributive purposes. Programs such as income security and Medicaid are primarily redistributive in the sense that most funds are passed through to individuals primarily on the basis of need. Other programs such as education, training, and transportation have distributional implications, but are motivated by other concerns. Most of the externality-based programs are matching programs, with the matching rate determined by a general formula with the actual rates varying state by state, or by project with little variation in rates. Of course, all of the categorical programs are conditional, in that the recipient jurisdiction must spend the money received to be entitled to participate in the program. And, while the matching programs make good economic sense as a matter of theory, empirical evidence does suggest that the programs do not operate in a vacuum, with political and bureaucratic forces playing an important role in the negotiation of matching rates (Oates, 1980, p. 334). The general revenue sharing program, on the other hand, is a non-categorical program which is redistributive in nature, with the redistribution occurring among jurisdictions, rather than among individuals.<sup>1</sup> Clearly such grants are not particularly effective for income distribution, since there is substantial income heterogeneity within most U.S. local jurisdictions, and especially within the larger metropolitan cities.

General revenue sharing (GRS) was first introduced as part of President Nixon's fiscal reform package in 1972. The Nixon program also included another series of block grants which involved more substantial restrictions.<sup>2</sup> While there are few restrictions, if any, in the GRS program, the extent to which redistribution occurs depends crucially on the formula chosen. In fact, the GRS program has not been very redistributive, since the formula is a rather complicated function of population, income, and tax effort.

Most of the growth in U.S. grants has been in the categorical area, and I expect (with some uncertainty) that this trend will continue. The GRS program is currently under reconsideration, with the possibility of its repeal a serious one. However, there has been a partial move towards the consolidation of categorical programs over the past decade. If the Reagan proposals are adopted, this consolidation will continue, with many individual programs eventually being eliminated.

### III. The Assignment of Taxes - The Question of Redistribution

I use a number of criteria in order to evaluate the current assignment of U.S. taxes. The first involves administrative costs. Other things equal,

Table 9.3

## GROWTH OF FEDERAL SYSTEM OF GRANTS

Year	Total Grants	Categorical Grants	General Purpose Grants	Block Grants	Total Grants As a Percentage of Federal Receipts	Total Grants As a Percentage of Gross National Prod.
	(\$ billion)	(\$ billion)	(\$ billion)	(\$ billion)	%	%
1950	2.3	2.0	0.1	0.2	5.8	0.8
1955	3.2	2.7	0.2	0.3	4.9	0.8
1960	7.0	6.5	0.2	0.3	7.6	1.4
1965	10.9	10.3	0.3	0.3	9.3	1.6
1970	24.0	23.2	0.4	0.4	12.4	2.4
1975	49.8	39.1	7.2	3.5	17.7	3.2
1980	91.5	72.6	8.6	10.3	17.6	3.5
1981	94.8	78.0	6.8	10.0	15.8	3.2
1982(est)	91.2	72.4	6.5	12.3	14.6	2.9
1983(est)	81.4	60.8	6.7	13.9	12.2	2.3

Sources: Gramlich and Laren (1982, Table 2); Advisory Commission on Intergovernmental Relations (1982b); U.S. Bureau of the Census (1981, Table 416); and Pechman and Bosworth (1982, Tables 2 and 5).

each level of government should employ the taxes that involve (relatively speaking) the lowest collection and enforcement costs. For example, one would expect local governments to utilize tax instruments which allow the governments to take into account specific information about the tax base and its appropriate valuation individual by individual or unit by unit. Similarly, local taxes are likely to be those (such as some user fees) for which there are not substantial cost advantages with size. The federal government, and to a lesser extent state governments, are better able to take advantage of administrative scale economics. And, to the extent that there are economies of scale in the collection of taxes, some sort of tax sharing arrangement could be motivated, with, for example, the federal government doing most of the revenue raising (see Netzer, 1974, for a study of property tax administration). However, there are some problems with a move towards the federal collection of taxes associated with the loss of spending control that might be felt by state and local governments.

To the extent that one chooses revenue sources on administrative grounds, the income tax seems to be best managed at the federal level, while the property tax is clearly a state or local tax. The advantage of a locally administered property tax is based on the fact that local assessors and administrators of the tax are acquainted in some detail with the specifics of the local real estate market (see Case, 1978; and Peterson, 1973). They can evaluate, perhaps better than anyone else, exactly what the effect of various zoning and land use regulations on property values might be. And, they might be able to determine with reasonable accuracy which neighborhoods should be reassessed, and with what frequency (subject to any restrictions given by state law). Of course, many of these functions could also be performed at the state level as well, especially in light of recent advancements in the use of computerized multiple regression assessment programs.

There has been a sense among some authors that it is desirable for various levels of government to avoid overlapping uses of taxes. However, there seems no reason in principle why such overlapping ought to be avoided, as there are not substantial scale economies or diseconomies in administration.<sup>3</sup> The tendency to avoid the 'piggybacking' of taxes - the use of a state or local supplementary tax levy applied to a tax base defined by a higher level of government and collected by the latter - seems to be more politically than economically motivated and should receive serious attention from tax reformers.

The second and perhaps the most important issue for the tax assignment question is one of distribution. The classical Musgravian view of the principles of fiscal federalism suggests that income distribution ought to be a federal responsibility. States and localities on the other hand, ought, to the extent possible, to allocate taxes on a benefits received basis. If benefit taxes are not possible, then user charges can provide a direct means of obtaining payment for the public services (see Musgrave, 1959, pp. 181-82; and Oates, 1968).

The argument of Musgrave takes for granted that the desire for income distribution is one that is nationally motivated, with tastes for distribution a function for all citizens' demands throughout the country. Of course, the argument must be altered if one has reason to believe that there are regional differences in preferences for income distribution. This may be in part what motivates the Reagan administration's desire to switch aid to families with dependent children (AFDC) from federal to state administration. If individuals in one state care more about income redistribution, the argument goes, why not allow states to be responsible for redistribution through their tax systems? While I cannot argue in this paper that such regional preferences do exist, I can point out that even if they do, the question of who ought to administer such redistribution is still at

issue. (This argument is made, for example, in Tresch, 1981.) One still needs to argue that with regional preferences, regional governments are best able to manage redistribution, since (subject to constitutional limitations) the federal government could manage differential redistribution if it were so desired. Of course, it will be difficult to obtain permanent differences in redistribution among areas because of the possibility of migration.

In fact, it is the possibility of migration that provides one motivation for Musgrave to make income distribution a federal responsibility. With a centralized tax system, the ability to avoid taxes legally is limited to the use of tax shelters and to a choice to migrate outside the confines of the United States (see Kakwani, 1978). An attempt to redistribute substantially at the state, or at the local level, is likely to be counterproductive, given the possibility of migration. This is particularly true to the extent that taxes are progressive at the high end of the income distribution, since higher income individuals are more likely to be mobile (for some evidence about this matter see Gramlich, 1978).

The question of whether and how taxes may affect locational choice cannot be answered without reference to the expenditure portion of the budget. Thus, for example, one can have a very progressive local tax without a locational distortion if the benefits associated with the tax are distributed in a pro-rich manner. As a result, it is misleading to analyze the distributive effects of state and local taxes without accounting for the expenditure side of the budget. It is the net difference between the benefits received and taxes paid that matters for locational decisions.

The empirical question of the incidence of the U.S. tax and expenditure system has been analyzed by a number of authors, each of whom must of necessity make a number of arbitrary assumptions in the process. However, to avoid controversy as much as possible I summarize the analysis of R.A. Musgrave and P.B. Musgrave (1976), which is based in turn on the work of Pechman and Okner (1974) and R.A. Musgrave, Case and Leonard (1974).<sup>4</sup>

At the federal level, the income tax is clearly progressive, despite the many deductions, exclusions and exemptions. On the assumption that the payroll tax incidence lies partly on the employees and partly on consumers (the employer's share), its overall incidence is regressive. The corporation tax incidence is difficult to evaluate, but under the assumption that half of the incidence is on consumption and half on capital income, the Musgraves conclude that the tax is regressive among those with low incomes and somewhat progressive among those with higher incomes. On balance, including the remaining sources of federal revenue, the federal tax system is mildly progressive. On the expenditure side, the number of assumptions implicit is large, but on balance the system is seen to be progressive with transfer payments excluded, and substantially progressive when they are included. Clearly there are substantial net benefits (expenditure benefits minus taxes paid) to those with relatively low incomes.

The story is quite different at the state and local levels of government. The general sales tax is assumed to fall on consumers and is seen to be regressive in nature, while the corporation tax has been previously described. Excises are also somewhat regressive, suggesting that the state tax system is slightly regressive. Local tax revenues are dominated by the property tax, whose incidence is also quite controversial, with the primary issue focused upon whether one views the tax as an excise tax from the point of view of a single community, or a tax on capital income viewed as a national tax on all business capital. R.A. Musgrave and P.B. Musgrave take a compromise view, assuming that the residential property tax falls on homeowners, the tax on rental housing on tenants (also somewhat controversial), and the business portion of the tax one-half on consumption (the excise part) and one-half on capital income (the national capital

tax).<sup>5</sup> On balance, the property tax is mildly regressive under these assumptions, making the overall state-local tax system also mildly regressive. The benefits of state as well as local expenditures tend to be pro-poor, again once one takes into account transfer payments. Without transfers the benefits are close to being proportional at the state level, and somewhat pro-poor at the local level. In any case, the net benefits also favor those with relatively low incomes, although to a much lesser extent than at the federal level.

If these simplified descriptions are accurate they suggest the difficulty of achieving redistribution in the U.S. at any level of government other than the federal. With net benefits not currently very large now, adverse locational incentives are limited.<sup>6</sup> However, with further redistribution at the state and more importantly at the local level, the migration incentives could become very important. Some improvement in administration of the various taxes as well as some reallocation of expenditure programs might 'improve' state and local equity, but attempts to achieve substantial redistribution are likely to be counterproductive.

#### IV. Tax Assignment - Efficiency in the Location of Economic Activity

The United States is a federal system with a large number of independent jurisdictions, including states, counties, municipalities, townships, school districts and special districts. In 1977, for example, in addition to the fifty states, there were over 3,000 counties, 18,000 municipalities, 16,000 townships, 15,000 school districts, and 25,000 special districts, a total of over 75,000 districts in all.<sup>7</sup> Most of these individual entities are rather small, making it quite possible that individual factors of production, labor as well as capital, will be mobile between them. As a result, a number of externalities arise when individual jurisdictions make spending and taxation decisions based solely on their own immediate self-interest. The externalities which occur on the expenditure side may be real, due to benefit spillovers, or pecuniary, due to output or factor price changes that result from spending decisions. However, the external effects which usually receive attention are largely pecuniary and arise on the tax side, either because non-residents pay a portion of taxes levied, or because the local tax decision affects the location of economic activity, thus altering tax revenues and causing congestion in other communities.

Of course not all tax differentials lead to locational inefficiencies. As mentioned before, any tax differences which simply reflect differential benefits and preferences associated with public services are not likely to be distorting. Thus from this point on, the discussion will assume *arguendo* that expenditures of the public sector are proportional to income, implying that distortions are associated with taxes that are not proportional, and thus not neutral with respect to location. I should also point out that any taxes which are pure profits taxes or pure taxes on rents will not distort location. In general, therefore, a reasonable procedure to achieving efficiency is to tax factors of production that are geographically immobile whenever benefit taxation is not possible. When there are no immobile factors, then the tax which is levied on relatively immobile factors is the best tax.<sup>8</sup>

A related efficiency issue arises because of the possibility of exporting taxes. Individual jurisdictions are likely to be biased towards the choice of tax instruments which allow them to place the largest share of the burden of the tax on non-residents of that jurisdiction. Exporting may arise in part because of the federal deductibility of state and local income, general sales and property taxes, and in part simply because residents of other jurisdictions pay either directly or indirectly a portion of the tax as consumers or factor owners.

Let me examine briefly each of the major taxes utilized by the state and local public sectors and evaluate them on these allocational grounds. First, consider the question of taxation of business. Businesses are taxed through various types of state corporate taxes (including a value-added tax in Michigan). In addition, businesses are taxed at the local level through the business component of the property tax. Most empirical studies suggest that even relatively high taxes on businesses do not have substantial locational effects. This may be because these taxes represent a small share of the cost of doing business. In addition, it may be because business taxes are capitalized into lower land prices and borne by landowners. But, it may also be because the studies are simply too aggregative to show impacts when they do occur. (Or, it may be because high taxes are accompanied by high quality and/or quantity of public services of value directly and indirectly to business.)

In any case the evidence that we do have suggests that business location between major urban areas is not likely to be dependent on the level of taxes, but location within metropolitan areas may well be tax sensitive.<sup>9</sup> Large tax differentials may well occur in some of the large metropolitan areas of the Northeast and Midwest. The result of such differential incentives is likely to be an increased rate of dispersal of business activity from the central city to the suburbs. All in all, the literature suggests that from a locational viewpoint one need not worry about reasonable use of corporate taxes at the state level, but that one should be concerned about differentials at the local level.<sup>10</sup> This conclusion is debatable, however, since the locational distortion of a relatively few large firms can cause substantial economic inefficiencies.

If one views the corporate income tax from an exporting perspective, the tax (through the excise effects of the tax) begins to look less desirable. Exporting may occur in a state such as Michigan if one makes the assumption that the automotive industry located in Michigan has national market power.<sup>11</sup> As this assumption is relaxed, a reasonable choice given the rather competitive nature of world automobile markets, one would expect less exporting of the tax. On the other hand, if the corporate tax is viewed as a tax on capital owners, a substantial portion of the tax will be borne by non-Michigan residents.

The individual income tax fares well at the federal level because of its easy administration and the possibilities for the design of a progressive system. At the state level the tax is a good revenue raiser as long as it continues to be proportional or mildly progressive. Currently rates are not sufficiently high (especially in light of the available state tax exemptions and deductions and the deductibility at the federal level) to have much adverse incentive in terms of location of individuals. At the local level, however, the income tax is not nearly as attractive. Administration may involve substantial difficulty, especially if the tax base is defined to be different than the federal base. (In Michigan, for example, the tax base is federal adjusted gross income less personal exemptions.) And, to the extent that tax bases vary among communities, the rates of taxation are likely to vary as well. (Often, however, tax bases are defined by state law, as, for example, in Michigan, Ohio and Maryland.) This could easily create locational disincentives, particularly in metropolitan areas where there are a large number of jurisdictions and a reasonably mobile population.

Moving back to the state level, the sales tax is worthy of serious attention. Most states in the U.S. utilize a broad-based sales tax as a major revenue source. Among the choice of state tax instruments, the sales tax gets reasonably good marks. On one hand, locational disincentives are not likely to be substantial, if only because of the large geographical area encompassed by most states. On the other hand, exporting of the tax can be substantial, since non-residents such as tourists are subject to the tax. To



the extent that exporting does occur, states may be encouraged to tax at a higher than efficient level.<sup>12</sup> At the local level, however, the exporting problem can be very serious if rates are not uniform across jurisdictions such as in New York. With uniform rates (as in Illinois) the local sales tax becomes similar to a state sales tax. On balance, given the relatively high administrative costs and the risk of serious locational disincentives, the sales tax is a poor choice for a local tax in the U.S. Of course, administrative costs would be reduced substantially if it were piggybacked onto the state sales tax.

Last, and certainly not least, is the residential property tax, the tax that has received the most adverse publicity in the United States over the past decade. This is probably due not to the nature of the tax itself, but because local referenda provide the most direct means by which individuals can voice their complaints about government in general. Despite a number of undesirable features of the tax, the property tax is in many ways a much better source of local revenue than are the alternative sales or income taxes. First, to the extent that the property tax liabilities are correlated with the benefits of local public services, the adverse locational incentives of tax differentials across jurisdictions are lessened. In fact, in the theoretical world of the Tiebout model, the property tax can serve as the basis of any efficient provision of local public services. According to this view, individuals choose among jurisdictions with varying service levels. Property taxes serve as benefit taxes, with local zoning ordinances chosen to eliminate inefficient locational distortions. While few if any economists argue that the Tiebout model is an accurate description of the property tax-public service allocation in the U.S., the model clearly has analytical and descriptive value, given the substantial diversity of service bundles and tax levels, and given the relatively frequent moves that households make.

Second, the portion of the property tax that falls on land will in general not have locational disincentives. However, housing property tax differentials can lead to inefficiencies if they alter the consumption choice between housing in the cities and housing in the suburbs and between housing and non-housing consumption. Of course the move to place greater emphasis on the taxation of land and less emphasis on the taxation of the structure would probably decrease adverse incentives from the local property tax, but this seems to be a change that is discussed more by economists than by policymakers. (To my knowledge Hawaii is the only state in which land is legally taxed at a higher rate than structures.)

User charges can be an efficient source of revenue, since they are likely to tie financing directly to the benefits of the provision of the services, making them in great part private rather than public in nature. Of course user charges are frequently quite regressive distributionally, but that is a different concern. As suggested in Table 9.2, state and local governments now receive about a quarter of their revenue from user charges, and with a growth of the tax limitation 'movement', I expect this number to grow over time (see Netzer, 1974).

Finally, I ought to mention a new rising source of taxation - the severance tax. A number of resource rich states have begun to apply relatively high rates of severance taxes as a means of raising substantial revenue. The legality of such taxes is still at issue, but the economic effects of such taxation can be severe. Severance taxes are useful to individual states because depending on the theory and the facts, they may be exported, and thus are likely to be raised substantially above levels that might be efficient. The severance tax might be an extreme example of a case where we need federal limitations over taxes so as to eliminate locational distortions.<sup>13</sup>

## V. An Evaluation of the Grant System

Among the important economic arguments for grants either at the federal or the state-local level are equalization and spillovers. I consider the latter argument first. Since there seems good reason to believe that spillovers are increasing (with population growth and increased density) rather than diminishing, a continued reliance on conditional categorical matching grants is appropriate. Whether such grants are best administered at the state or federal level is a separate question. With programs that generate broad social benefits, federal administration is advisable. However, some programs generate spillovers which affect neighboring jurisdictions within states, but for which there may be less social consensus. In this case state administration of grant programs would seem in order.

The Reagan program for restructuring the grants program in the U.S. contains two elements which are relevant here. The program suggests a move from greater federal participation to greater state participation in the allocation of grants. I have argued that such a move may make good economic sense, if the states do pick up their responsibilities. However, the Reagan program also proposes a move from categorical to non-categorical programs with substantial consolidation. This is inconsistent with the usual economist's argument for the treatment of spillovers. If the final outcome of such a reform is the reduction of grant programs overall, a likely result in light of current state-local fiscal stringencies, then none of the grant program goals suggested here will be achieved.

It is perhaps more interesting to reflect on the distributive or equalizing nature of grants. Income distribution by the U.S. grants system is concentrated in the U.S. welfare system, a primarily federally financed operation. President Reagan's suggested switch of responsibility from the federal to the state level seems contrary to the notion that the problem of poverty is best handled as a national problem. If the program were left to state governments, states with relatively low fiscal capacity would be unable to provide sufficient income support for their poor individuals. The inability of states to manage these programs themselves can be seen when one looks more explicitly at the variation in per capita income and tax capacity among states.<sup>14</sup> The distribution of low income population in the U.S. varies substantially among states. And, as a general rule, those states with individuals most in need are not generally those most capable of financing state and local expenditures. For example, Mississippi had 26.1 percent of its population below the poverty line in 1975, but had a per capita personal income equal to 69 percent of the national average, and a taxable capacity of 71 percent of the national average. Delaware, on the other hand, had only 8.2 percent of its population below poverty, but had a per capita income of 112 percent of the average, and a taxable capacity of 125 percent.<sup>15</sup> What is surprising about these figures is that despite the substantial variation in taxable capacity, the United States has spent relatively little money on pure redistribution at the federal level. (For a comparison of U.S. spending to that in other countries see Advisory Commission on Intergovernmental Relations (1981b); and chapters in this volume.)

But should grants be used to eliminate differences in taxable capacity? The usual argument for equalizing grants assumes that with unequal capacities, certain 'important' services cannot be provided at a minimum level. Some authors have argued further for equality in the provision of certain public services. However, the issue for most economists is whether it is necessary to equalize jurisdictional spending when the ultimate goal is usually thought to be distributional equity among individuals. At this point a convincing case for equalizing jurisdictional spending has yet to be made.<sup>16</sup> In fact, little attention has been given in the U.S. (unlike many other federal countries) to the question of fiscal equalization.

Perhaps less surprising than the relative lack of concern for distribution at the federal level is that disparities in taxable capacity are even greater within states than they are among states. Yet, relatively little attention has been given to the use of state grants to redistribute between jurisdictions, at least until the last decade.<sup>17</sup> I can illustrate this point by comparing the substantial disparities within the state of Michigan to comparable national data. For the United States as a whole, I divided the fifty states into ten groups of five each, on the basis of per capita personal income. In the first group containing the top five states in terms of per capita personal income, the median or third state has an income of approximately 14.4 percent above the mean income for the entire nation. The median of the lowest group (i.e. the bottom five states) in terms of per capita personal income has a median income equal to 80 percent of the nation mean. When I calculated comparable numbers for Michigan counties, I found a greater disparity in income. The group of counties representing the top one-tenth in terms of per capita income, has a median income 6.2 percent above the state average. However, the median income for the lowest group is only 57.4 percent of the average (see Michigan State Tax Commission, 1980, Table 1; and Verway, 1980, Tables I-4 and VI-7). Clearly, inequality in the distribution of income among counties is greater than it is among states in the U.S., a fact which is quite consistent with the Tiebout story told earlier. The same is true if we look at measures of taxable capacity. In the United States the capacity based in terms of an income measure is 20 percent above the mean for the highest of five states, and 79 percent of the mean for the lowest of five states. However, in the state of Michigan the highest eight counties are 91 percent above the average, while the lowest are at 75 percent of the average.<sup>18</sup>

The focus has been on the property tax, since the property tax is the major source of local revenue, but the same general pattern would occur were one to alter the property tax and move to an income tax or sales tax. To the extent that one is concerned about distribution among jurisdictions, within-state interjurisdictional tax base differentials become important. If equalization within states is deemed desirable, a case can be made for a greater role for state non-categorical grants from the state to local governments. The same line of reasoning could be used to argue for the statewide taxation of property. (For a substantial discussion of this issue, see Brazer, 1961, pp. 137-47.)

The problem of local disparities is best illustrated by the challenges to the use of the property tax as a means for financing schools. Tax base differences clearly lead to substantial differences in the ability of communities to raise revenue for support of schools and may be correlated with individual income differences as well. Whether current arrangements for financing are legal or not is a question whose answer varies from state to state. Further, whether a move away from current financing towards a more equalizing scheme is a desirable one, seems problematic (see Inman and Rubinfeld, 1979, for discussion of this issue). The reason is that disparities in the ability of different communities to raise taxes have already, to some extent, been capitalized in property values. As a result, individuals residing in high tax base jurisdictions may not be 'wealthy' since they may have paid for entrance into the community through a premium or higher price paid for a house. And, correspondingly, individuals in low tax base communities may be living in relatively cheaper housing which may compensate them in part or in whole for the higher cost of public services. In addition, equalization may limit the kinds of choices that might be available for individuals making a locational decision. As a result, there is an inherent equity-efficiency tradeoff in which greater equity reduces the potential advantages of a Tiebout-type outcome.

Where does all this lead us? My inclination is to fall back on the proposition that the concern about jurisdictional disparities within

states<sup>19</sup> is based at least substantially on an underlying concern for income redistribution. Yet, the relatively low correlation between per capita property value and income limits the ability of government to redistribute income through base equalization. All in all, the federal government should probably play a larger rather than smaller role in dealing with income distribution problems. Contrary to current proposals, this would involve picking up a larger rather than a smaller share of the current welfare system. State control over income distributional programs would have associated with it the possible adverse effects due to migration. In addition, in a world in which there are limited choices and local governments are competing, there is little reason to believe that the choice of benefit levels will be optimal. For example, it is possible that governments will underprovide benefits, since they will view the potential cost of any program, not simply the current cost, but also the potential future cost when low income individuals migrate to that community when benefit levels are raised.

An additional problem that needs treatment relates to the spending effects of the grant system. The usual view is that non-categorical, non-matching grants serve simply as increments to local or state income. Since only a small proportion of income is spent on state and/or local public goods, the addition of such grants is likely to lead primarily to tax reduction rather than to spending increases, at least in the long run. Even categorical grants will not be stimulative of local spending dollar for dollar because some of the pre-grant spending may be displaced into other public spending or into tax reduction (for extensive discussion of this literature, see Gramlich, 1977). However, a less well understood issue involves the fact that grants, even those that are non-matching, seem to have a greater stimulative effect on spending than one would otherwise expect. The argument here is that local bureaucrats and politicians, with a shorter time horizon than their constituents, choose to spend more of the grant money than the usual model might predict. This 'flypaper effect', that money sticks where it hits, has been acknowledged for a long time, but only recently has its implications been pursued in some detail.<sup>20</sup> If non-categorical grants are overly stimulative for this reason, they will lead to inefficiently high spending by localities. As a consequence one may have reason to think about either cutting back on these programs or introducing certain kinds of restrictions on the ability of states and localities to spend - i.e. tax and spending limitation. The more direct alternative - to alter the current federal system so as to eliminate the potential fiscal illusion that appears to bring forth this overstimulative effect - may not be feasible.

There is another side to the issue of stimulation by grants. Matching rates for programs such as AFDC vary among states, depending upon the income of the individual states. A switch of the federally financed portion of AFDC to the state level, as suggested by President Reagan, would substantially alter spending incentives. Under the current system, the price to the states of funding additional AFDC benefits is substantially less than a dollar, since the average state-wide matching ratio is approximately sixty cents.<sup>21</sup> After the program becomes a state program, the cost of financing becomes one dollar on the margin. Obviously, the increased price will lead to an incentive to spend less, with the incentive varying from state to state. In particular, since matching rates are highest in poor states, leading to lowest prices, the adverse stimulative effect on spending will be worse in the lower income states. To the extent that the goal of the program is distributive, the move from federal to state control with the elimination of the matching component is likely to have perverse consequences. (This argument is made in greater detail in Gramlich and Laren, 1982.)

Finally, I want to focus on the role of federal grants as a stabilizing device. In general, recessions can have substantially adverse effects on the

budgets of state and local governments. States and localities in the United States rely primarily on income, sales, and property taxes whose nominal rates are politically rather difficult to change in the short run. As GNP falls during a recession, tax base will also fall, leaving governments with a difficult budget balance problem. The problem is diminished somewhat because the property tax base is rather insensitive to the business cycle. However, the problem is exacerbated by the expenditure side of the budget. With limited flexibility due to contractual obligations, the net result is substantial budgetary deficits at the state and local levels.

Of course, similar cyclical effects may occur at the federal level. But, in the United States most states require that the budget be either balanced or in surplus. The budget balance requirement can limit the ability of state and local governments to stabilize the regional economy. These problems cannot be fully avoided by a grant system, but a federal system can help to ease the cyclical budgetary effects. It should be pointed out in fairness that the view that state-local spending is deflationary is a debatable one. For example, Gramlich and Laren suggest that in the aggregate state and local budget services are not very sensitive to changes in GNP, although the cyclical variation among individual communities may be substantially larger. In addition, Oates (1980) and Gramlich (1978) suggest that grants do not serve as a countercyclical policy instrument in terms of their effect on state-local budgetary behavior.<sup>22</sup> How important these problems are or are likely to be is one that is clearly worthy of further study.

## VI. Conclusion

Given the rather complex nature of the U.S. federalist system, it is difficult to reach any general conclusions. However, given the nature of the externalities generated in a world of numerous relatively small jurisdictions, a number of tentative claims can be made.

- (1) To the extent that one wishes to achieve substantial individual income redistribution, the federal level is the appropriate spending level. In general the U.S. system has tended to follow this approach, but the current Reagan Administration proposals are likely to be contrary to such a goal.
- (2) Taxes ought to be allocated to levels of government, based on the mobility of the factors being taxed, the possibility of tax exportation, and the more general set of externalities that might be associated with alternative tax bases. The relatively high reliance of some states on the corporate income tax is hard to evaluate, because of uncertainty about its incidence, but is likely to have been a bad choice (along with several other taxes) from the efficiency standpoint because of the possibility of exportation.<sup>23</sup> The sales tax looks better on both allocative efficiency and administrative grounds. The increased emphasis on the use of flat rate state personal income tax is generally consistent with several of the efficiency goals. However, it is more costly to administer than the sales tax and not neutral with respect to saving.
- (3) At the local level the continuing reliance on the property tax, at least the tax on residential property, seems to be appropriate. The property tax base is easier to administer than other taxes, unless localities piggyback state taxes. Efficiency problems are likely to be more serious in terms of commercial and industrial base (although capitalization could eliminate this inefficiency), making a move to a statewide taxation worthy of serious consideration.

- (4) There is likely to be a continuing important role for grants in the U.S. federalist system both at the federal and state levels. Whether the move by the new federalism will place greater weight on state financing is not so clear. The nature of spillovers involved and the relatively great variation in income and taxable capacity within states argues for a greater state role. However, this conclusion must be tempered by the fact that we still do not have a strong normative basis for equalizing taxable capacity within states. If substantial redistribution is to be achieved a greater federal role would be appropriate.

#### NOTES

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- 1 For a more complete discussion of the rationales of our grant systems, see Break (1980a) and Break (1980b).
- 2 These included community development block grants, comprehensive employment and training assistance, and social service block grants.
- 3 There is some overlapping of the income tax, and to a lesser extent of selective sales taxes at both the federal and state levels. For a much more extensive discussion of the administrative costs of utilizing various taxes, see Netzer (1974) and Advisory Commission on Intergovernmental Relations (ACIR) (1966) and (1964).
- 4 See also the paper by Inman and Rubinfeld (1979, pp. 1662-750).
- 5 I should note that the Musgrave and Musgrave view is contrary to contemporary opinion about the property tax, since it focuses on current income, rather than including imputed rental income and/or permanent income.
- 6 Of course this statement only talks about the 'average' case. Incentives may still be very large at the extremes of the income distribution.
- 7 See Verway (1980, Table IX-1) and ACIR (1981, p. 13). Note that the number of all districts has declined since the 1940s, with the biggest decline in the number of school districts. The number of special districts has grown rapidly, however.
- 8 I should use 'mobile' here in a very broad sense, allowing for all means of avoiding the tax, including less work effort. In addition, I should not rule out the use of consumption-based taxes, which do not distort the consumption-savings choice.
- 9 For a more complete discussion of locational effects see Due (1961, pp. 163-73); Carlton (1979, pp. 13-49); McLure (1974); Vasquez and deSeve (1977); and Advisory Commission on Intergovernmental Relations (1967).

- 10 This argument provides one basis for supporting a move to the statewide taxation of industrial and commercial property, an idea proposed by Brazer (1964, pp. 137-47) several decades ago.
- 11 Roberts (1975) suggests that 42 percent of the corporate income tax is borne by residents. In comparison, he concludes that 82 percent of the property tax on owner-occupied housing is borne by residents. Comparable numbers for the sales tax are 73.9 percent, for the state personal income tax, 76.6 percent. The Roberts analysis should be treated with care since a number of rather strong and debatable assumptions are implicit in his work.
- 12 See McLure (1967, pp. 49-77) for estimates of exporting by state and Roberts (1975) for an analysis of the incidence of Michigan's sales tax.
- 13 For a thorough discussion of the effects of severance taxes see Gillis and McLure (1975, pp. 389-96); Cuciti, Galper and Lucke (1983); and the Mieszkowski paper in this volume (Chapter 6).
- 14 The differences in poverty may be overstated because they do not account for cost of living differences. See Ladd (1982) for further discussion.
- 15 Alaska, a somewhat unusual example because of its natural resource base, had only 6.7 percent in poverty and a per capita personal income equal to 165 percent of the average. See ACIR (1982a, Table 3) and U.S. Bureau of the Census (1980).
- 16 The debate has received greatest attention within certain states in which the question of reform of local school finance has focused on distributional inequities among local jurisdictions. For a discussion of the general issue of revenue sharing versus redistribution of income, see Bradford and Oates (1971, pp. 416-39). For a discussion of the distributional issues in school finance, see Inman and Rubinfeld (1979, pp. 1662-750).
- 17 A number of 'foundation' grant programs do date back to the 1920s, however.
- 18 The tax capacity measure for Michigan is based on state equalized valuation, an equalized measure of property assessments. We did not use a broader measure of tax capacity for the U.S. because the inclusion of natural resource deposits suggest some unusual results for Alaska, Nevada, Texas, Wyoming and California.
- 19 The focus on equities solely in terms of taxable property base per capita may overstate the extent to which disparities actually exist. Were we to move towards a broader notion of tax capacity, as has been suggested by the Advisory Commission on Intergovernmental Relations, we might find the problem to be less serious.
- 20 See Courant, Gramlich and Rubinfeld (1979, pp. 147-57); and Oates (1979, pp. 23-29) for an additional discussion of this subject.
- 21 This does not account for the deductibility of taxes. See Gramlich and Laren (1982) for details.
- 22 See Gramlich and Laren (1982) for further details. See also Oates (1980, pp. 331-57) for a useful discussion of the role of grants in stabilization.

- 23 This is not necessarily so. Suppose that some state/local public services are inputs into the production function for private goods. Then it may be necessary to tax firms so as not to induce the overutilization of these public service inputs.

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# TAX ASSIGNMENT AND REVENUE SHARING IN THE UNITED STATES

Commentary

by

Wallace E. Oates\*

The Rubinfeld paper provides an excellent description and assessment of the vertical structure of the U.S. fiscal system. As he emphasizes, the most striking characteristic of the U.S. system is its diversity. Looking across the fifty states, one finds a remarkable variety of governmental organization and institutions: differences in the level of government at which functions are performed, in the types and extent of reliance on particular tax instruments, and in the role and magnitude of intergovernmental grants. Fiscal averages for state and local governments, while useful for certain purposes, can conceal much of interest in the United States.

Moreover, the U.S. fiscal structure is by no means static in character. The Reagan proposals for a 'New Federalism' represent the latest chapter in the evolution of the U.S. federal system. I find myself basically in agreement with Rubinfeld on his assessment of the Reagan proposals.<sup>1</sup> First, I agree that the initiative to turn the primary responsibility for assistance to the poor over to the states is ill-advised. The President's claim is that: 'Financial assistance to the poor is a legitimate responsibility of States and localities'. However, for the reasons that Rubinfeld spells out, the constraints on state and local policies for income maintenance are very real ones. While not subscribing to a 'purist' position that says that the support of low-income households is solely a central-government function, I would argue vigorously that the federal government has a basic responsibility for this function - a responsibility that is not consistent with the assignment of the programs for aid to families with dependent children (AFDC) and food stamps to the states.

Second, the New Federalism proposals seem to me on somewhat firmer ground in terms of their objectives of consolidation of categorical grants and the decentralization of certain allocative functions. The U.S. federal system has undergone a rather helter-skelter evolution that, as Rubinfeld notes, has resulted in a bewildering array of over 500 (often overlapping) federal grant programs. A reassessment and elimination or consolidation of many of these programs is long overdue. My one hesitation on this issue concerns the rather indiscriminate manner in which this consolidation process appears to be proceeding. As Rubinfeld emphasizes, certain categorical grant programs have a legitimate role to play; they can serve, for example, to encourage the provision of particular state and local services where there is a broader national interest (or, in the economist's jargon, where there are 'external benefits'). This would suggest a careful, case-by-case reappraisal of existing grant programs to determine which of these have a legitimate rationale. However, it is more my sense that the Administration is rushing towards the consolidation of all politically accessible categorical grant programs without much attention to their legitimacy.

More generally, Rubinfeld examines the vertical assignment of taxes in the U.S. federal system and the structure of existing intergovernmental grants. Again I find myself basically in accord with his assessment. For some general observations on the tax assignment problem and equalizing grants, I refer the reader to my discussion of the Mathews paper in this volume. Here, I wish to take up a specific issue on which there was some discussion and considerable disagreement at the conference: the macroeconomic or countercyclical role of intergovernmental grants. Rubinfeld suggests that the cyclical budgetary problems of state and local governments

may be substantially eased by a heavier reliance on federal grants. There was, in this regard, a recent proposal in the United States for the introduction of 'countercyclical revenue-sharing' under which supplementary revenue-sharing funds would be made available during times of recession.

Proposals for countercyclical federal assistance to the states and localities have a considerable history dating back at least to Hansen and Perloff (1944). It was their contention that because of existing balanced-budget provisions in most state constitutions, the decline in tax revenues in a recession would induce spending cutbacks thereby accentuating the deflationary pressures. This view of state-local budgetary behavior came to be known as the 'fiscal-perversity' hypothesis, and gave rise to proposals for federal assistance to state and local government in bad times to offset this procyclical pattern of state and local fiscal activity.

However, a closer examination of this matter raises serious questions about the effectiveness and desirability of such measures.<sup>2</sup> First, an historical examination of the record in the United States and in Canada does not support the fiscal-perversity hypothesis. Such studies find that the state-local sector has, in fact, exerted a stabilizing influence on the national economy. Second, the evidence is not at all reassuring on the effects of such grants on state-local budgetary behavior. In a set of studies, Edward Gramlich (1978, 1979) used his econometric model of state and local budgetary activity to estimate the response of state and local expenditure to increases in various forms of federal aid. His estimates are quite striking: Gramlich finds that in the short run only a minute fraction of such assistance will find its way either into increased spending or tax relief. The great bulk is simply absorbed into increased stocks of financial assets giving little stimulus to the economy.

The Gramlich findings thus cast serious doubt on the countercyclical potential of intergovernmental grants in the United States. There is, moreover, evidence from other federal countries like Canada and Federal Republic of Germany that likewise suggests little scope for such programs. In the West German case, for example, attempts in the 1960s by the central government to neutralize procyclical investment activity by the states with supplementary grant assistance appear to have been ineffectual (see Knott, 1977).

The evidence can hardly make one very sanguine over the prospects of an effective macroeconomic role for intergovernmental grants. At the same time, however, several participants at the conference were reluctant to accept a wholly negative verdict. Particularly over the course of a prolonged recession, as the states and localities exhaust their fiscal reserves (as appears to be the case currently in the United States), the balanced-budget constraint will begin to bite and impose fiscal restraint on the public budget. In such circumstances, the fiscal-perversity proposition may come to have some validity - and increased central assistance may prove helpful.<sup>3</sup>

#### NOTES

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1 For a more detailed assessment of the New Federalism, see Oates (1982).

2 For a study of the potential of countercyclical intergovernmental grants, see Oates (1980).

- 3 This view, of course, presupposes that the central government is in a position and willing to run the necessary budgetary deficit and that such deficits, functioning in a Keynesian way, do not fully crowd out an equivalent amount of private expenditure.

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# TAX ASSIGNMENT AND REVENUE SHARING IN THE UNITED STATES

Commentary

by

Wilfred Prest\*

Professor Rubinfeld describes his paper as primarily descriptive. His American colleagues may not all agree with every detail of his presentation, but as an interested outsider and occasional visitor I must say how useful it is to have the relevant data presented in such a convenient and readily available form.

It is of interest first of all to learn that the Reagan administration has produced another brand of 'New Federalism'. Not that there is anything particularly new in the proposed switch of some expenditure responsibilities from the federal to the state governments, or in the consolidation of some categorical grants into block grants. Both were espoused by the Nixon administration, and copied to a limited extent by the Fraser government in Australia. Perhaps the one thing that is new is the device of an interim trust fund into which federal grants are to be paid pending their eventual replacement by increased state tax revenues.

Section II of the paper examines the background against which the proposed new arrangements will have to operate. The data presented in Tables 9.1 and 9.2 show that, in the United States, government spending as a percentage of Gross National Product (GNP) has risen substantially since World War II; that a sizeable proportion of State and local spending is sustained by federal grants; and that there is a great deal of tax overlapping and duplication. Of these three characteristics the first two are not peculiar to the United States and could be matched if not surpassed in other federations, but the third is uniquely distinctive. There are obvious disadvantages in the opposite extreme of one government collecting most taxes, as in Australia, but for some taxes at least joint collection and tax sharing arrangements may have distributional and efficiency advantages, as Rubinfeld subsequently demonstrates, although he is perhaps unduly sceptical about the administrative economies that might also accrue to both governments and taxpayers.

Section III of the paper proceeds to examine the distributive effects if state and local tax rates have to be increased following the curtailment of federal grants. State and local tax systems are held to be mildly regressive, rather than mildly progressive like the federal system. Increased reliance on them will therefore lead to a less equitable distribution of income, except insofar as 'pro-poor' expenditure can thereby be increased. The possibility of the migration of well-to-do taxpayers between localities, however, leads Rubinfeld to the conclusion that any major transfer of redistributive functions from the federal to state-local governments might be 'counterproductive'. This seems to be a problem peculiar to the United States. In Australia at least constitutional and other factors preclude any major transfer of redistributive functions from the federal to the state-local sector, which in any case has only a very limited range of tax-benefit options.

Section IV of the paper discusses the efficiency effects of the relocation of factors of production resulting from increased tax rates, where such increases are not offset either by increased expenditure or by tax exportation to other communities. The opportunities for relocation are naturally greater amongst small local jurisdictions than amongst the states themselves. To the outside observer the number and variety of local units



in the U.S.A. is even more bewildering than the extent of tax overlapping and duplication. However, the figures quoted by Rubinfeld show that multipurpose local units (counties, municipalities and townships) account for less than half the total, the remainder being single purpose units, such as school districts and miscellaneous special districts. By comparison schools in Australia are administered directly by the states and special purpose units such as those for country water supply are generally thought of as state agencies. As such they are clearly subordinate to the states, but the same is also true of Australian multipurpose units. Last year, for example, the Melbourne City Council and its Lord Mayor were dismissed by the state government of Victoria and replaced by three appointed commissioners. Such drastic action may be rare, but it suggests that one solution to the problems that arise when local units are unable to administer or finance the programs assigned to them is for the states to restructure and if need be amalgamate them, in the same way as the number of school districts in the United States has been reduced substantially since 1967. In a federal system the integrity of the states is protected by legal and constitutional guarantees, but the local units have no protection other than what may be afforded by the constraints of state politics. The common practice of referring to local units as a third level of 'government' is thus misleading. At best they are a third level of administration - voluntary, mostly unpaid and hence relatively cheap. The process of devolution downwards whereby the states have established local units may be contrasted with that of integration upwards whereby they established federal governments in both the United States and Australia. This conference has perhaps been a little too preoccupied with the integration model. There are in fact some federations, notably India, in which the states themselves were established by devolution downwards from a pre-existent centre. The result of this type of devolution is, however, somewhat different from that whereby the states have created local administrative units.

Section V of the paper proceeds to evaluate proposed changes in the role of intergovernmental grants. The adverse distributive and efficiency effects of higher tax rates in the states and local units would seem to increase their need for federal grants, but according to the data presented in Table 9.3 categorical grants are expected to decline in 1983 and general purpose and block grants will increase only marginally. The need for continued federal assistance for redistributive purposes is highlighted by the disparities in state fiscal capacity. The states where poverty is most prevalent are the ones where taxable capacity is below average. This deficiency could be remedied by increased federal grants but Rubinfeld casts doubt on the need to equalize jurisdictional spending, when the ultimate goal is distributional equity amongst individuals. Australian experience suggests a further consideration. For many years the Commonwealth government has given general purpose grants to states with relatively low fiscal capacity to enable them to maintain services at standards not appreciably below, and at tax rates not appreciably above, those of the more fortunate states. For nearly fifty years such 'special grants' have been made on the recommendation of the Commonwealth Grants Commission, but the Commissioners have never regarded their task as one of equalizing living standards in all parts of the federation. Instead the purpose has been to ensure that no state defaulted on its public debt, because default on the part of one state would adversely affect the credit of all. Government debt is another of the matters which have not attracted much attention at this conference, except incidentally with reference to stabilization policies. In Australia most state debt has been incurred for development rather than for stabilization purposes, including the building of railways and electric power schemes which have mostly been developed by private enterprise in the United States.

My final comment relates to the heavy reliance of local units on property taxation as their main source of revenue. On the basis of per capita fiscal capacity and personal income in the counties of the State of Michigan,

Rubinfeld concludes that disparities amongst local units in both fiscal capacity and in income needs are wider than amongst the states. Hence the need for redistributive policies is greater, but so too is the difficulty of financing them at the local level. In this context it is perhaps worth reminding ourselves that the system of local property taxation in English-speaking countries is derived from the old English Poor Law. The original purpose was clearly redistributive and the tax base was mainly residential real estate which was taken as a proxy for personal income and ability to pay. Perhaps the present difficulties arise from an over-extension of the tax base to cover other forms of property and from a corresponding over-extension of the range of local services to include, for example, schools and roads as well as poor relief. Rubinfeld proposes cutting back the local tax base by subjecting property other than residential real estate to a state-wide tax levied on behalf of the local units. Perhaps if the range of services to be supported by the property tax were also narrowed we should get back to a more workable arrangement.

#### NOTE

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