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The Federal Tax Sharing Idea

John Shannon

THE FEDERAL TAX SHARING IDEA

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This afternoon I would like to answer five questions that are usually posed when the whole subject of Federal tax sharing with State and local governments is raised.

1. What is the basic idea underpinning this tax sharing proposal?
2. Why is this idea generating so much attention?
3. What has been the general public reaction to it?
4. How has this tax sharing idea been translated into proposed legislation?
5. What are its prospects in terms of early legislative adoption?

Revenue Sharing Idea

The basic idea behind revenue sharing is quite simple—strengthen the fiscal independence of State and local governments by requiring the National Government to share a designated portion of its income tax revenue with State and local governments *on a no expenditure strings basis.* Thus, the essence of the revenue sharing idea is Federal aid with no controls.

This proposition reflects the growing recognition across the political spectrum that the National Government simply lacks the power, personnel and perspective to heal all the Nation's ills. There is also the necessary corollary—increasing public support for policies that promote the decentralization of authority and responsibility.

Increased support for the general idea of decentralization is not the only factor working in behalf of revenue sharing. The emergence of this Nation as a super power with massive foreign commitments makes it necessary to develop new safeguards designed to prevent the short-changing of our domestic needs in general and our domestic instrumentalities (State and local governments) in particular. Witness this assessment by Daniel P. Moynihan:

> As far as I can see, an American national government in this age will always give priority to foreign affairs. A system has to be developed, therefore, under which domestic programs go forward regardless of what international crisis is preoccupying Washington

> at the moment. This in effect means decentralizing the initiative and the resources for such programs.[1]

The sharing of Federal revenue with State and local governments in good times and bad times is responsive to this need to decentralize both initiative and resources.

This concern for strengthening the position of State and local governments also reflects the powerful attraction that the concept of "balance" exerts within our federal system. We are still receptive to the idea of "leaning against the wind"—of resisting those tendencies and forces in our system that if unchecked would result in a disproportionate amount of political power being lodged at any one level of government. Thus, in colonial times the federalists sought ways of strengthening the National Government, without undue sacrifice of the powers of the States. Contemporary "federalists" are now searching for ways to strengthen the States and localities without undue sacrifice of National goals. Because money and political power are so inexorably intertwined, this search concentrates on developing fiscal mechanisms—such as revenue sharing—a means best calculated to use the unquestioned revenue superiority of the National Government to reinforce the advantages of a decentralized system of government.

The Fiscal Propellant

Two of the most disturbing tendencies in contemporary federalism, however, provide the real drive for revenue sharing. To put it another way, the reason this proposition is generating so much attention can be attributed to both the growing revenue superiority of the National Government and its failure to develop an alternative to the present system of Federal categorical grant programs with their countless expenditure strings, conditions, and "guidelines."

Federal Revenue Raising Superiority

The enormous "automatic" revenue growth capability of the Federal income tax contrasts too sharply with the second and third rate revenue generating systems of State and local governments—a fact that both creates a radical fiscal imbalance and poses a clear and present danger to the integrity of the federal system. Without changing a word of the Internal Revenue Code, Federal income tax receipts will automatically increase by approximately $10 billion annually in response to normal economic growth.

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[1] *Congressional Record*, September 26, 1967, p. H. 12499. Speech to meeting of Americans for Democratic Action, September 23, 1967.

While the National Government, therefore, can count on higher revenue yields generated by economic growth to accommodate most of its expenditure needs, State and local policymakers are forced to rely far more heavily on political action. There is constant need to impose new taxes and to raise the rates on existing taxes. For example, a study by the Commission staff revealed that between 1950 and 1967 only 47 percent of the increase in major State taxes—income, and general and selective sales taxes—was the result of economic growth while 53 percent resulted from legislative enactments.

In addition to this automatic growth superiority, the National Government enjoys another revenue raising advantage—its freedom from the hobbling fears of interlocal and interstate tax competition. The more limited a government's jurisdictional tax reach, the more apprehensive the government becomes about its relative tax climate. Two great forces are heightening this sensitivity to intergovernmental tax competition—the growing desire of State and local policymakers to promote economic development and the increasing interdependence of our economy.

This overall revenue superiority of the Federal Government relative to State and local governments threatens the integrity of the federal system—an arrangement of shared power that rests on an unstated premise that each level of government will experience about the same degree of resistance when tapping the taxpayer's pocketbook.

Federal Aid Categories—Too Numerous and Too Narrow

The lopsided reliance on one method of delivering Federal aid—the narrow categorical or conditional approach—constitutes a second threat to the federal system. In effect the Congress is dangling over 400 large and small fiscal carrots worth more than $25 billion before the eyes of State and local governments and special interest groups. Each carrot has been chosen hopefully to provide sufficient financial incentive to spur the States and localities on to greater action in some field of "national interest." But evidence abounds that State and local governments have difficulty absorbing a large number of diverse programs over restricted periods of time. Moreover, we have seen that the sheer number of these Federal incentives, each designed to accomplish a different objective, can produce managerial apoplexy if not financial exhaustion for those jurisdictions not able to devote the time and resources necessary to track down and match the last available Federal aid dollar.

Progressive loss of freedom, moreover, is an additional price that must be paid by all State and local jurisdictions, rich or poor. Professor Walter Heller, both a keen student of our intergovernmental fiscal system and a prominent member of the liberal establishment has traced the ominous implications for our system of decentralized power.

"Unless this trend is reversed, Federal aids may weave a web of particularlism, complexity, and Federal direction which will significantly inhibit a State's freedom of movement. The picture of Gulliver and the Lilliputians comes to mind." [2]

Public Reaction

The tax sharing proposal has generated a most curious political response—applause from the middle and shrill outcries of opposition from those at either end of the political spectrum. According to public opinion polls the great majority of the American public favors revenue sharing. This group, however, becomes a "silent" majority alongside the strident extremists on the left and the right.

Those ultra liberals who hold strong "centralist" views regard this proposition as fiscal madness. In their judgment the idea of turning Federal dollars over to governors and mayors with no strings attached is akin to a father turning a substantial part of his income over to his young children with no questions asked.

Thus, those who take the position that Papa (National Government) always knows best can be expected to throw plenty of sand into the revenue sharing gears.

At the other end of the political spectrum we find the arch conservatives who also view this idea as dangerous—but for far different reasons. In the judgment of these conservatives one must never divorce the pain of taxation from the pleasure of expenditure.

There is another curious similarity between the ultra liberals and the arch conservatives—their gloomy prognosis for the Nation if revenue sharing becomes a reality. The "centralist" liberal fears that once revenue sharing becomes a reality the "free" or unconditional dollar will drive out the conditional aid dollar. They predict that Congress will be under increasing pressure to dismantle its present conditional aid system and transfer the dollars now earmarked for conditional aid into the revenue sharing pot. Many conservatives, on the other hand, are concerned because they believe that these same "free" Federal dollars will remove a powerful brake on "big spending" at the State and local level—the politically painful necessity of having to vote heavier local taxes to satisfy increased expenditure demands. Thus, revenue sharing is denounced by those on the left for undermining Federal controls and by those on the right for undercutting fiscal responsibility.

In my judgment these gloomy predictions are totally unrealistic. There is no indication that the Congress has any intention of presiding

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2 Heller, *New Dimension of Political Economy,* Cambridge; Harvard University Press, 1966.

over the liquidation of the categorical aid system thereby renouncing its control and influence over the great domestic programs operated by State and local governments. About the most that can be expected is greater Congressional receptivity to the general idea of building more flexibility into its aid structure. This can be accomplished by both tidying up the categorical landscape (the streamlining and consolidation of many of its narrow categorical aid programs) and by adding the second aid dimension—revenue sharing.

The Advisory Commission also rejects the argument that unconditional assistance would be frittered away by the irresponsible and capricious acts of State and local officials. Even a cursory examination reveals that education, health, welfare and highway needs determine State expenditure priorities in very much the same way as they influence Congressional aid decisions. Moreover, the charge of irresponsibility invariably rests on the highly questionable tendency to generalize from a few particular instances. There is also the obvious rejoinder that if we want State and local policymakers to assume a more responsible part in governing and servicing the needs of the American people they must be treated as responsible partners in our federal system.

Finally, it is inconceivable that revenue sharing would ever reach such massive financial dimensions as to obviate the necessity for State and local fiscal prudence. Just as Congress will not preside over the liquidation of the categorical aid system there is no reason to believe that they will permit State and local trucks to be backed up to an open Treasury door. About the best that the State and local governments can expect is "free" access to a highly limited section of the Federal tax preserve.

Current Status of Revenue Sharing

Two revenue sharing bills now command Congressional attention—the Nixon Administration's version (S. 2948) recently introduced by Senator Baker and co-sponsored by most of the Senate Republicans and the Advisory Commission's proposal introduced by Senator Muskie and Senator Goodell (S. 2483—Title I).[3]

The point must be emphasized that the Muskie-Goodell revenue

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[3] In addition to the revenue sharing title, this omnibus measure for strengthening the fiscal position of State and local governments provides for a partial Federal tax credit for State income tax payments (Title II), authorization to the Treasury to collect a State income tax under terms mutually satisfactory to the Treasury and the State government (Title III), and a liberalization of the Federal credit for State death tax payments (Title IV). This bill carries an estimated "price tag" of approximately $23 billion over the next three fiscal years.

sharing plan is similar in philosophy and fairly close in major detail to that advanced by President Nixon. In order to strengthen the fiscal position of State and local governments, both the Muskie-Goodell and the Baker bills would divert a portion of Federal revenue, albeit limited, for sharing with States and localities on a no-strings-attached basis.

The initial distribution under the President's proposal calls for an outlay of $0.5 billion in 1971 rising to approximately $5 billion by 1976, whereas the Muskie-Goodell bill would authorize the distribution of $3.4 billion in 1971 rising to approximately $5 billion in 1976. In determining the size of each State's entitlement, both bills use essentially the same approach—population modified by tax effort (Table I).

Under both revenue sharing proposals Virginia would receive about $22 million for each $1 billion. Thus, under the Muskie-Goodell plan Virginia would receive close to $70 million the first year of operation.

While both bills initially channel all funds to the State, they differ considerably when it comes to the subsequent reallocation of Federal revenue sharing funds to local governments. The President's proposal mandates a "pass through" of funds to all cities and counties, regardless of their population size with the entitlement for each locality determined by the proportion that its locally raised revenue bears to total State-local revenue. Thus, if a city's locally raised revenue accounts for 10 percent of all State and local revenue raised within that State it is automatically entitled to 10 percent of the State's share.

In order to give the States greater discretion in the distribution of revenue sharing dollars to its localities, the Muskie-Goodell bill limits the mandatory pass through of funds to those cities and counties with population in excess of 50,000. To be more responsive to the big city fiscal crisis the Muskie-Goodell bill also provides that these more populous units of local government share in the State's entitlement in the same proportion that double their taxes bear to total State-local taxes. Thus, whereas Norfolk would receive 3.8 percent of the Virginia entitlement under the Administration proposal, it would receive 6.7 percent of the Virginia share under the Muskie-Goodell bill.

While these differences may appear significant, they must be viewed as negotiable. The friends of revenue sharing dare not become too stiff-necked when it comes to details. The revenue sharing proposal is too important for the future well being of our federal system to be lost because of disagreements on these secondary issues.

Future Prospects

What is the prospect for early enactment of revenue sharing? Right now I would not put it better than 2 out of 5—as far as enactment within the next two years is concerned.

As previously noted, the friends of revenue sharing are exposed to a cross fire laid down by the extremists at both ends of the political spectrum. In addition, the Congress may leave the fiscal cupboard bare in its effort to effect tax reform by means of tax reduction. There is also the uneasy alliance between governors and mayors—a union that could rupture completely if the mayors attempt to ram through a revenue sharing measure that would by-pass the States completely.

Finally, there is always the question of the so-called alternatives to revenue sharing—an issue that inevitably arises when the revenue sharing proposal is debated.

The alternatives are far reaching—Federal assumption of State and local welfare costs, larger Federal grants for education, special aid to the major central cities and Federal tax credits for State income tax payments. While many of these specific proposals have been endorsed by the Advisory Commission, the fact remains that this discussion of alternative methods certainly muddies the revenue sharing waters. To paraphrase the Bard—under such circumstances revenue sharing tends to become sicklied over with the pale cast of doubt and loses its name of action.

This was probably what one Governor had in mind as he handed out this piece of advice to a group of businessmen, "I understand that tomorrow your program calls for a debate on revenue sharing. In my judgment this is a complete waste of your valuable time. You don't debate revenue sharing—you support it with everything you've got!"

The Governor is absolutely right—the cause of revenue sharing and federalism will be better served by turning out more missionaries and fewer debaters. Those of us who believe that the maintenance of a system of shared power is fundamental to the American governmental system should give *highest priority* to the enactment of a revenue sharing bill. We must establish the principle that State and local governments should have free, albeit limited, access to the nation's prime power source—the Federal income tax. To put the issue more bluntly, the time has come to truly federalize the Federal income tax.

APPENDIX TABLE 1

COMPARISON OF SHARED REVENUE ALLOCATIONS, BY STATE
(FOR EACH $1 BILLION)*

STATE	ALLOCATION (MIL.)		PERCENT DISTRIBUTION	
	S. 2483	President's Proposal	S. 2483	President's Proposal
UNITED STATES	$ 1,000 0	$ 1,000.0	100.00	100.00
Alabama	15.8	16.1	1.58	1.61
Alaska	1.2	1.2	.12	.12
Arizona	10 0	10.1	1.00	1.01
Arkansas	9.2	9.5	.92	.95
California	111.0	112.5	11.10	11 25
Colorado	11.0	11.6	1.10	1.16
Connecticut	12 6	12 8	1.26	1.28
Delaware	2.5	2.4	.25	.24
District of Columbia	3.5	3 4	.35	.34
Florida	31.2	30.8	3.12	3.08
Georgia	20 7	20.8	2.07	2.08
Hawaii	5 0	4.8	.50	.48
Idaho	4.2	4 0	.42	.40
Illinois	42.2	44.5	4.22	4.45
Indiana	24.6	24.2	2.46	2.42
Iowa	13.7	14.6	1.37	1.46
Kansas	11.6	12.1	1.16	1.21
Kentucky	14.8	14.8	1.48	1.48
Louisiana	19.9	20.3	1.99	2.03
Maine	5.0	5.1	.50	.51
Maryland	19.4	18.1	1.94	1.81
Massachusetts	30.4	29.6	3.04	2.96
Michigan	40.8	40.8	4.08	4.08
Minnesota	21.1	21.5	2.11	2.15
Mississippi	12.3	12.6	1.23	1.26
Missouri	21.0	20.4	2.10	2.04
Montana	3.8	3.9	.38	.39
Nebraska	6.4	6.6	.64	.66
Nevada	2.5	2.5	.25	.25
New Hampshire	3.2	3.1	.32	.31
New Jersey	32.3	31.1	3.23	3.11
New Mexico	5.4	5.7	.54	.57
New York	122.5	117.1	12.25	11.71
North Carolina	23.4	24.2	2.34	2.42
North Dakota	3 4	3 5	.34	.35
Ohio	40.5	41.2	4.05	4.12
Oklahoma	12.8	12 6	1.28	1.26
Oregon	11.0	10 4	1.10	1.04
Pennsylvania	53 9	53 3	5.39	5.33
Rhode Island	4.0	4 3	.40	.43
South Carolina	11.8	12.1	1.18	1.21
South Dakota	3.7	3.9	.37	.39

Comparison of Shared Revenue Allocations, By State
(For Each $1 Billion)*
—(Continued)

STATE	Allocation (mil.)		Percent Distrtbution	
	S. 2483	President's Proposal	S. 2483	President's Proposal
Tennessee	$ 17.8	$ 18.1	1.78	1.81
Texas	45.8	47.7	4.58	4.77
Utah	5.8	5.7	.58	.57
Vermont	2.3	2.4	.23	.24
Virginia	21.7	20.4	2.17	2.04
Washington	16.7	16.2	1.67	1.62
West Virginia	9.1	9.0	.91	.90
Wisconsin	23.1	24.2	2.31	2.42
Wyoming	2.1	2.1	.21	.21

*The differences in the State allocations produced by the two plans can be attributed to the fact that S. 2483 gives greater weight to the most recent increase in State-local tax effort and has a somewhat narrower definition of revenue effort.

APPENDIX TABLE 2

COMPARISON OF LOCAL GOVERNMENT ALLOCATIONS, 70 LARGEST CITIES AND COUNTIES[1]
(FOR EACH $1 BILLION OF REVENUE SHARED)

Unit of Local Government (Descending Order of Population)	Units Share Under—		Percent of Total State Area Entitlement		Per Capita Share	
	S. 2483	President's Proposal	S. 2483	President's Proposal	S. 2483	President's Proposal
	(thousands)					
New York, N.Y.*	$ 71,303	$ 34,029	58.23	29.06	$8.89	$ 4.24
Los Angeles Co., Calif.	13,586	6,908	12.25	6.14	1.99	1.01
Cook Co., Ill.	2,067	1,170	4.90	2.63	.38	.22
Chicago, Ill.	8,106	4,312	19.21	9.69	2.30	1.23
Los Angeles, Calif.	6,642	3,735	5.98	3.32	2.41	1.35
Wayne Co., Mich.	1,988	1,155	4.87	2.83	.73	.43
Philadelphia, Penn.	8,445	4,424	15.66	8.30	4.14	2.17
Cuyahoga Co., Ohio	1,237	659	3.06	1.60	.71	.38
Detroit, Mich.	4,545	2,460	11.14	6.03	2.74	1.48
Alleghany Co., Penn.	1,557	853	2.89	1.60	.97	.53
Harris Co., Texas	1,141	553	2.49	1.16	.74	.36
Nassau Co., N.Y.	3,344	1,511	2.73	1.29	2.37	1.07
Middlesex Co., Mass.	368	184	1.21	.62	.28	.14
San Diego Co., Calif.	1,454	754	1.31	.67	1.23	.64
Orange Co., Calif.	1,841	956	1.66	.85	1.57	.82
Dallas Co., Texas	644	301	1.41	.63	.55	.26
Houston, Texas	2,542	1,331	5.55	2.79	2.22	1.16
Erie Co., N.Y.	2,155	960	1.76	.82	1.98	.88
Dade Co., Fla.	2,022	1,297	6.48	4.21	1.87	1.20
Milwaukee Co., Wisc.	1,813	910	7.86	3.76	1.74	.88
Alameda Co., Calif.	1,501	810	1.35	.72	1.46	.79
King Co., Wash.	849	402	5.10	2.48	.84	.40
Essex Co., N.J.	1,475	666	4.56	2.14	1.51	.68
Suffolk Co., N.Y.	1,266	597	1.03	.51	1.32	.62
Santa Clara Co., Calif.	1,532	821	1.38	.73	1.65	.88

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(FOR EACH $1 BILLION OF REVENUE SHARED)
—(CONTINUED)

Unit of Local Government (Descending Order of Population)	Units Share Under—		Percent of Total State Area Entitlement		Per Capita Share	
	S. 2483	President's Proposal	S. 2483	President's Proposal	S. 2483	President's Proposal
Baltimore, Md.*	$ 5,781	$ 2,634	29.74	14.55	$ 6.26	$ 2.85
Hamilton Co., Ohio	448	272	1.11	.66	.49	.30
Hennepin Co., Minn.	1,310	602	6.21	2.80	1.49	.68
Westchester Co., N.Y.	1,047	527	.85	.45	1.20	.61
Bergen Co., N.J.	721	376	2.23	1.21	.83	.43
St. Louis Co., Mo.	824	375	3.93	1.84	.97	.44
Dallas, Texas	2,118	1,083	4.62	2.27	2.50	1.28
Maricopa Co., Ariz.	853	401	8.48	3.97	1.02	.48
Cleveland, Ohio	1,865	1,088	4.61	2.64	2.30	1.34
District of Columbia*	3,470	3,400	.....	.....	4.31	4.22
Oakland Co., Mich.	374	192	.92	.47	.47	.24
Bexar Co., Texas	255	119	.56	.25	.32	.15
Franklin Co., Ohio	454	227	1.12	.55	.59	.29
Milwaukee, Wisc.	1,695	1,045	7.35	4.32	2.22	1.37
Marion Co., Ind.	654	281	2.65	1.16	.88	.38
San Francisco, Calif.	4,681	2,576	4.22	2.29	6.55	3.60
San Antonio, Texas	792	482	1.73	1.01	1.12	.68
Shelby Co., Tenn.*	2,125	967	1.19	5.34	3.05	1.39
St. Louis, Mo.	2,950	1,444	14.07	7.08	4.26	2.09
Boston, Mass.*	4,737	2,374	15.58	8.02	7.07	3.54
Jefferson Co., Ky.	623	300	4.22	2.03	.94	.45
San Diego, Calif.	985	686	.89	.61	1.49	1.04
Monroe Co., N.Y.	1,446	667	1.18	.57	2.20	1.02
New Orleans, La.	1,796	1,074	9.03	5.29	2.77	1.65
Jefferson Co., Alabama	910	420	5.75	2.61	1.42	.65

COMPARISON OF LOCAL GOVERNMENT ALLOCATIONS, 70 LARGEST CITIES AND COUNTIES[1]
(FOR EACH $1 BILLION OF REVENUE SHARED)
—(CONTINUED)

Unit of Local Government (Descending Order of Population)	Units Share Under—		Percent of Total State Area Entitlement		Per Capita Share	
	S. 2483	President's Proposal	S. 2483	President's Proposal	S. 2483	President's Proposal
Jackson Co., Mo.	$ 380	$ 161	1.81	.79	$ .59	$ .25
Hudson Co., N.J.	809	373	2.50	1.20	1.31	.60
Seattle, Wash.	1,040	731	6.24	4.51	1.79	1.26
Columbus, Ohio	751	507	1.85	1.23	1.32	.89
Pittsburgh, Penn.	1,747	826	3.24	1.55	3.12	1.48
Atlanta, Ga.	1,241	757	6.00	3.64	2.32	1.41
Kansas City, Mo.	1,536	871	7.33	4.27	2.95	1.68
Indianapolis, Ind.	1,031	513	4.18	2.12	2.00	.99
Cincinnati, Ohio	1,460	1,306	3.61	3.17	2.92	2.61
Denver, Colorado	1,701	978	15.42	8.43	3.48	2.00
Buffalo, N.Y.*	1,773	867	1.45	.74	3.69	1.80
Minneapolis, Minn.	1,130	651	5.36	3.03	2.43	1.40
Newark, N.J.*	2,396	1,045	7.41	3.36	6.07	2.65
Louisville, Ky.	1,267	1,014	8.59	6.85	3.23	2.59
Portland, Oregon	1,016	566	9.22	5.44	2.64	1.47
Miami, Fla.	1,057	502	3.38	1.63	3.25	1.54
St. Paul, Minn.	927	473	4.39	2.20	3.01	1.54
Tampa, Fla.	763	431	2.44	1.40	2.50	1.41
Rochester, N.Y.*	1,223	597	1.00	.51	4.06	1.98
Dayton, Ohio	765	400	1.89	.97	2.88	1.50
35-Cities	155,277	81,212	.....	.....	3.35	1.87
35-Counties	55,073	27,727	.....	.....	1.19	.59
Total	210,350	108,939	.....	.....	2.27[2]	1.23[2]

[1]Includes the 35 counties with the largest population and 35 of the largest cities, based on 1966 population estimates. Excludes the following five large cities for which 1966 population figures were unavailable, with 1960 population in parenthesis: Honolulu (500 thousand); Memphis (498 thousand); Phoenix (439 thousand); Oakland (368 thousand); and Fort Worth (356 thousand).
[2]Unweighted average.
*This share reflects the fact that the jurisdiction's revenue system also underwrites the cost of local schools.