Revenue Sharing - An Idea Whose Time Has Come - Almost

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MARKS the twentieth year of publication for the DePaul Law Review and provides an appropriate occasion indeed for a review of Federal-State relations in American federalism. As one element of this symposium, this paper considers current policy concerns about revenue sharing, an idea whose time has come—almost!\(^1\) At the moment a not inconsiderable variety of fiscal proposals parade under the caption of revenue sharing; however, the basic idea is simply the sharing of revenue by the national government with some set of subfederal governments in order to strengthen their fiscal capabilities. In other words, revenue sharing amounts to the award of federal, unconditional—or relatively unconditional—grants to subnational governmental units with the grant amounts being a function of, or related to, particular revenue yields rather than, or in addition to, the categorical or functional grants that have proliferated so rapidly since this Journal began twenty years ago. Consideration of this topic includes: (1) causes for revenue sharing proposals; (2) the cases for and against the concept of revenue sharing that have developed during the nine-year seasoning period that has passed since the idea first attracted national attention; and (3) the evolving compromises that appear to be on the verge of producing a consensus that may result in legislative action which will make revenue sharing an integral component of the fiscal pattern of federalism in the United States.

Financing American federalism has seldom been easy and has almost always generated debate. The recent past and our present situation provide no exception to this generalization. Economic growth causes increases in federal tax revenues because of the progressive rate structure of the federal tax system. Simultaneously, the by-products of such growth creates new and additional program requirements for state and local governments without materially increasing their revenue-raising capacity. Few of the congeries of contemporary problems fail to contribute their fair share to increased governmental costs. The result is an imbalance between fiscal needs and resources at the subnational level where there is no fiscal policy justification for unbalanced budgets.

This "fiscal mismatch" of needs and resources creates a continuing fiscal crisis at the state and local level. Moreover, the state and local governments' capacity to effectively respond to this problem is often further reduced by the fragmentation of local government units and the existing distribution of legal authority between state and local governments. This state of affairs provides one rational basis for revenue sharing proposals designed to provide subnational governments access to that magnificent fiscal engine, the federal income tax.

INTERGOVERNMENTAL FISCAL RELATIONS:
SEARCH FOR A NEW EQUILIBRIUM

Given the very real complexity of American federalism, a variety of approaches to intergovernmental programming and fiscal coordination have developed both in practice and from academic discussions. A sampling of approaches includes: (1) separation of tax sources; (2) coordinated tax administration; (3) coordinated tax bases including tax supplements and credits; (4) centralized tax administration; (5) uniform laws; (6) functional grants-in-aid; (7) unconditional grants-in-aid; and (8) shifts in the locus of program or functional responsibility. These approaches have generated much debate and a corresponding prolific amount of literature almost ex-

ceeding the writings induced by the antitrust laws. In this intellectual area, ancient political ideas interact with current arcane economic concepts and produce only one conclusion—no one grand solution is either readily or obviously available. No single approach provides in and of itself a satisfactory solution to the fiscal problems of federalism. Both the public and their policy-makers are faced with the perennial question of what “mix” of policies seem best at a particular time and what rate of incremental change is appropriate. At the moment, the American federal system moves in its own peculiar fashion at a rather glacial pace toward a new fiscal balance. Analysis of this complex matter is clearly beyond the scope of this article, although the emergent dimensions of new arrangements merit passing notice since they, if and when adopted, will serve to condition both prospects for enactment of revenue sharing and what may reasonably be expected to result from its existence as one element in the changing fiscal base of American federalism. Recently, expert analysts of contemporary government have suggested state assumption of the costs of public education and federal government assumption of the fiscal burdens of public assistance, including medicaid. While such proposals offend at least some conventional wisdom, they do outline a genuine series of possibilities that have obvious relevance for the changing design of our fiscal system. We assume, at this point, the gradual fiscal federalization of welfare. Also our reading of the aftermath of Serrano v. Priest, suggests that states will remain under significant pressure to accept increased direct responsibility for school finance. Within this evolving context, revenue sharing, while hardly a panacea and certainly lacking the capacity to solve many problems, may


5. 5 Cal. 3d 584, 96 Cal. Rptr. 601, 487 P.2d 1241 (1971).

well be an acceptable but second-best solution to many of our inter-governmental fiscal problems.\(^7\) It does seem to be an appropriate means of revitalizing the federal system and increasing the range of options available.\(^8\) It can appropriately be included as one element contributing to a new balance in fiscal federalism. While *natura non facit saltum* remains accurately descriptive of our public policy decision-making pattern, revenue sharing seems an appropriate next, but by no means final step. This tentative conclusion suggests the merit of examining the background and the pros and cons of revenue sharing as a prelude to a final evaluation of the concept.

**REVENUE SHARING: A SUMMARY OF PAST DEVELOPMENTS**

While federal fiscal aid to state and local governments is virtually as old as the nation, Congress has rather consistently attached conditions to or limited the scope of particular grant programs.\(^9\) Unconditional transfers have been rare, if not altogether unknown in American fiscal history.\(^10\) Current consideration of revenue sharing began in 1964 when Walter Heller, then Chairman of the Council of Economic Advisors, proposed revenue sharing as a device to permit the states to receive the benefit of anticipated federal "fiscal dividends" in order to help correct the fiscal drag.\(^11\) What has come to be known as the Heller-Pechman plan for revenue sharing had marked attractiveness and appeared to receive endorsement from both sides of the political aisle.\(^12\) While all com-

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10. See Bourne, *The History of the Surplus Revenue of 1837* (1885).
ment was by no means favorable, the concept was readily assimilated to the conventional wisdom of the times.

Walter Heller described his proposal in the Godkin Lectures as follows:

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

After some five years of public discussion, President Nixon sent Congress a plan for revenue sharing in August, 1969 which, if adopted as proposed, would have established a distribution increasing in amount over time to one percent of federal personal taxable income. This transfer to state and local governments would have been based on population ratios and tax efforts of the various states with an automatic distribution to local governments based upon the ratio of state to local government revenue raised in a particular state. All cities, towns and counties would have shared in this intergovernmental transfer payment pattern, but special purpose districts were excluded. Subsequently, amid a plethora of discussion, a wide variety of revenue sharing proposals have been made. The suggestions vary, as might be expected, in terms of: (1) amount; (2) duration, (3) distribution formula, (4) participation by particular local government units—e.g., the "pass through" problem, (5) the scope of expenditure control and the appropriate objects of expenditure—the "strings" or "no strings" question, and finally, (6) the ancillary requirements attached, such as modernization of state and local government structure or improvement of subnational government revenue systems, as conditions precedent to receipt of some or all of the revenue shared. At the time of this writing, the media suggests that these matters not only can, but shortly will, be compromised and that the House Ways & Means Committee of the Congress will soon approve a


As already indicated, the core idea of revenue sharing includes: (1) setting aside a percentage of the federal individual income tax base; (2) automatically allocating this sum to the states annually to be spent by them without material restriction; (3) this amount to be distributed on a formula basis using population and some measure of tax effort with some distribution to local governments. What are the arguments in favor of such an arrangement? Walter Heller has well stated one aspect of the matter as follows:

In a basic sense, the case for shared taxes begins with the conviction that strong and financially viable states (interpreted to mean 'state-local governments') are essential to (a) a healthy federalism and (b) optimality in the performance of public services.

In part, this simply expresses the traditional faith in pluralism and decentralization, diversity, innovation, and experimentation. For those who lack that faith—for died-in-the-wool Hamiltonians and for those who believe that the states are bound to wither away—there can be little attraction in revenue sharing or other instruments relying heavily on local discretion and decision.

Yet, apart from the philosophic virtues of federalism, all of us have a direct stake in the financial health of state-local governments for the simple reason that they perform the bulk of essential civilian services in the country.

Thus, one justification for revenue sharing is that it would nourish state-local programs, thereby making for effective subnational governments as well as enabling economically weaker states to provide adequate minimum service levels. As has been suggested else-
where, "Nevertheless, revenue sharing seems to be an appropriate means of loosening up the system and increasing the range of options open to subfederal governmental jurisdictions in the American federal system." 10 Another justification for revenue sharing is that it is anticentralist and thus, supports traditional power diffusion and deconcentration. 20 Certainly, it would assist in balancing state budgets—a by no means unimportant factor. 21

Economist George Break has provided one apt as well as succinct statement of the case for revenue sharing in these words:

The basic case for the adoption of revenue sharing at this time rests on the proposition that state and local governments are presently unable, for reasons beyond their control, to provide the level of local and regional public service benefits that their residents really would like to purchase, or that today's societies regard as an absolute minimum. There are three major potential barriers to the optimal provision of local public service benefits in a federal system of government:

1. Because they operate in relatively open economic environments, subnational governments may be deterred from raising tax rates by fear of generating adverse migration effects.
2. State and local voters may be unable to agree on the appropriate mix of benefits-received and ability-to-pay elements in the taxes needed to finance the programs they desire.
3. Specific state and local governments may lack the resources needed to support those levels of local public service that a large majority of the people in the country would regard as the minimum required for civilized existence. 22

With this the case for revenue sharing can rest. Revenue sharing, while no panacea, accords with federalism, offsets the fiscal mismatch, provides limited interstate equalization and, in effect, strengthens the federal system. In a larger sense, as former Secretary John B. Connally has suggested, it is a reaffirmation of faith in American federalism and in the American people. 23

THE CASE AGAINST REVENUE SHARING:
FORCEFUL CHALLENGES TO THE IDEA

Opposition to adoption of revenue sharing finds justification in

19. Supra note 8.
a variety of ideas ranging from a fear of federal dominance of local affairs to the presumed superiority of categorical grants compared to the unconditional variety. At least some of these arguments merit review. Ancient wisdom suggests the propriety of tax levy and expenditure decisions at and by the same level of government. Separating the two, as commonly suggested, will separate right from responsibility and lead to decisional profligacy by the spending unit. There is, of course, much good sense in this view; however, it is difficult to argue convincingly that federal policymakers now exercise effective expenditure control especially in the meaningfully labelled "uncontrollable" areas of the federal budget. It is at least no more difficult to contend that state and local officials would clearly recognize that waste of revenue sharing funds would require higher taxes and the political accountability that such decisions entail. Moreover, some expenditure constraints will doubtlessly be added to whatever revenue sharing arrangement is ultimately adopted and one should not be without some considerable faith in the Comptroller General and the General Accounting Office.

A more effective criticism is simply that there is no uncommitted federal fiscal dividend either now or in the foreseeable future and that, in effect, there is nothing to share; or to put it more accurately, that there are more pressing national priorities such as federalization of fiscal responsibility for welfare and income maintenance as well as federal financial responsibility for a minimum program component of elementary and secondary education. This observation may be and often is coupled with the fact that some states have excessive needs and low incomes, while others have high incomes with included low-income problem enclaves. George Break once again provides an effective rejoinder:

My conclusion, however, is that we need both aid to poor people and aid to poor governments, that income maintenance programs are capable of achieving only the former goal, and that revenue sharing, in a form not very different from the original Heller-Pechman plan, is a simple and reasonably effective means of


raising the level of public service consumption to acceptable standards for people who otherwise would not be able to achieve them.26

Moreover, while national problems require action, our public institutions, including state and local government, clearly must be equipped to perform their basic functions as well as provide "service stations" to which the federal government can delegate the implementation of various programs. Overcoming advanced obsolescence in public institutions is in itself a matter of considerable priority.

Numerous other alleged negative by-products of the adoption of revenue sharing have been noted by critics and analysts.27 However, adoption of revenue sharing hardly seems likely to seriously undermine the categorical grants system. The common argument that states should pay their own way and that revenue sharing will create a dependency, have elements of truth yet seem basically unpersuasive. Revenue sharing is seldom touted as the best or a perfect solution to fiscal imbalance; it is merely the best of the worst.28 Accordingly, in our view, the weight of the argument favors early adoption of the revenue sharing concept.

THE MATTER OF CUTTING UP THE PIE: DISTRIBUTION OF FUNDS

At the time of this writing, a tentative consensus on the details of revenue sharing appears to be developing.29 Basic questions concerning alternative revenue sharing proposals include: (1) the method of determining annual amounts to be shared; (2) determining the formula for distribution of shared funds to recipient governments; (3) specifying the share, if any, of local governments; (4) the matter of what restrictions (strings) will be placed on the expenditure of such funds; and lastly (5) the question of what ancillary conditions will be required for qualification as a recipient.30 These issues appear well on the way to resolution.

30. For a comprehensive analysis see Weidenbaum and Joss, Alternative Ap-
While initial revenue sharing proposals contemplated continuing appropriations increasing over time, it now appears, as exemplified by the Mills Bill, that a fixed dollar amount limited to a five-year initial trial run of the revenue sharing idea is a more likely outcome. Similarly, although the Heller-Pechman proposals suggested distribution on a per capita basis, they were adjusted for subnational government tax effort. Sections 102 and 103 of the proposed Intergovernmental Fiscal Coordination Act of 1971 (the Mills Bill), for example, would distribute one-half on a population basis and one-half on the basis of the recipient government's proportion of families with incomes under $4,000. This arrangement weights the distribution in terms of need as measured by low family income.

The Mills Bill would provide $3.5 billion for local governments and $1.8 billion for state governments annually for a maximum of five years. The local government share would be distributed, as already indicated, on the basis of population adjusted for urbanism and low-income families in the recipient jurisdiction. This, then, is the response in this draft legislation to the problem of transferring funds to the local governments. On balance, this appears to be an effective and satisfactory resolution of the problem. It has already attracted significant support from the nation's governors and mayors. 31


32. As this article was going into print, these compromises had been worked out in the State and Local Fiscal Assistance Act of 1972, H 14370: "House-Senate conferees have reached agreement on the $30.1 billion five-year revenue sharing plan. The funds would be divided one-third to states and two-thirds to local. The key compromise came when it was decided to give state governments the option of utilizing either the Senate rural-oriented or House urban-oriented distribution for-
and appropriate fashion. The original Heller-Pechman plan and the proposal urged by President Nixon were essentially unconditional grants to local governments; i.e., revenue sharing on a “no-strings-attached” basis. Inevitably the “no-strings” concept generates concern and opposition. From a Congressional standpoint, the problem is insuring proper use of federal funds which are subject to Congressional control and for the expenditure of which Congress is ultimately responsible, even though the absence of adequate output measures renders program evaluation rather anemic if not impotent.33

From the viewpoint of subnational governments, especially when they are poor, there are at least two relevant considerations. First, there is the question of regional variation in priorities and problems. Uniformity is not necessarily a guarantor of program or expenditure effectiveness. Accordingly, some considerable delegation of expenditure control appears desirable. Second, experience from the categorical grants area suggests that rigid and particular specification of expenditures provide few, if any, incentives for local officials and administrators to be creative in designing and implementing effective programs. A basic dichotomy results. Congress seeks to retain control in order to achieve national objectives; local units naturally desire local control not only for its own sake but also in order to acquire or retain the capacity for developing responsive, effective

mula. Local governments would use the funds according to the Senate formula for maintenance operations, public safety, environmental protection, and public transportation." CCH CONG. INDEX, Report Letter No. 92, Sept. 27, 1972. See also Strauss, Revitalizing Our Federal System: The Rationale for Revenue Sharing, in this issue of the DE PAUL L. REV.

33. On this latter point Charles L. Schultze offers a telling comment as follows: “Two major consequences flow from failure to provide performance measures related to program objectives. The first is the growth of detailed regulations which rigidly specify what is 'acceptable' behavior by subordinate decisionmakers. Standard contract provisions multiply and are required to be included in all contracts regardless of their suitability to a particular situation. Tables of organization are centrally established and carefully monitored. Elaborate procedures are developed to control the purchase of supplies, the use of long-distance communications, travel, and the like. Since subordinate decisions cannot be controlled by judging them in terms of their effect on output, they are controlled by a rigid specification of inputs.”

programs. In a sense, curing the fiscal mismatch entails effective handling of the administrative power mismatch in contemporary American federalism. Assuming a continuation of the present categorical grants system and its possible future expansion, adoption of revenue sharing should allow for regional and local variation in the implementation of national objectives so as to maintain and enhance the viability of the federal system.

The Mills Bill, which Congressman Mills has said represents his efforts to find a satisfactory alternative to revenue sharing, illustrates one approach to the "strings" or "no-strings" question. Section 101 provides that payments to local governments may be used only for "high-priority expenditures" which are defined in part in Section 102 as follows:

For purposes of this title, the term 'high-priority expenditures' means only—

(1) maintenance and operating expenses for—
   (A) public safety (including law enforcement, fire protection, and building code enforcement),
   (B) environmental protection (including sewage disposal, sanitation, and pollution abatement),
   (C) public transportation (including transit systems and streets),
   (D) youth recreation programs,
   (E) health,
   (F) financial administration, and

(2) capital expenditures for—
   (A) sewage collection and treatment,
   (B) refuse disposal systems,
   (C) public transportation (including transit systems and street construction),
   (D) the acquisition of open space for parks and public facilities, and
   (E) urban renewal programs.

This proposed constraint provides one resolution to basic questions about the scope of permissible expenditures from shared revenues. It appears to be a realistic and acceptable compromise which maintains some reasonable local expenditure flexibility as well as federal oversight.

A final area in the "strings" versus "no-strings" debate is the question of what additional conditions, other than the usual post-audit procedures, must be met by a subnational government in order for it to qualify as a recipient of shared revenues or appropria-
tions made for transfers in lieu of revenue sharing per se. Naturally, a wide spectrum of conditions might be attached to legislation of this type. Federal policy could insist upon some degree of state and/or local government modernization and structural reorganization. Alternatively, it could provide incentives for significant change in state revenue systems. Section 202 of the proposed Intergovernmental Fiscal Coordination Act adopts the latter approach by providing that state allocations are to be limited to 15 percent of the amount of revenue derived from the state individual income tax during the previous year. Thus, states which refuse to impose state income taxes would be ineligible for any federal revenue-sharing funds. Optional federal collection of state income taxes is also provided but will not be considered here, since it involves numerous questions of intergovernmental tax coordination which transcend the revenue sharing question. Since a personal income tax is a logical component of a high quality state tax system, this incentive proposal is an appropriate condition.

SUMMARY

Current debate on fiscal federalism and revenue sharing seems to be moving toward a positive compromise, including adoption of a modified form of revenue sharing or block grants with some rather reasonable strings attached. While precise prediction, especially in an election year, is premature, it does appear that revenue sharing is an idea whose time has almost come. The proposed Intergovernmental Fiscal Coordination Act provides one acceptable response to the 1964-1972 debate on revenue sharing. Enactment of this proposal or a similar variation would make a useful and needed contribution to the effective financing of American federalism.
