# REVENUE SHARING AND REGIONAL EQUALIZATION

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## I

One of the significant features which prevails in many of the proposed revenue sharing schemes in the United States is a provision calling for some form of equalization among states. Of the 90-odd separate revenue-sharing bills introduced in the 90th Congress, 61 included population as a major factor determining the allocation of federal funds (3). The much-debated Heller-Pechman Plan proposes granting of funds among states on the basis of population; thus, a state with high per capita income would pay more into the fund than it would receive and conversely a low income state would receive more than it contributes. Heller states that "Ideally any plan should reduce inequalities and fiscal disparities among states," (11). Further, "A significant part of the case for revenue sharing rests on its role in narrowing the gaps in service levels between wealthier and poorer states," (10).

The tax credit plan of the type advanced by the Advisory Commission on Intergovernmental Relations does not involve equalization among states.[1] Some proponents of the plan, however, are apologetic about (and opponents critical of) its failure to equalize. "Shortcoming(s)," it is said, "could be remedied and a significant degree of interarea equalization could be effected by a system of negative tax credits . . ." (13). The proposed Intergovernmental Revenue Act of 1971 introduced by Senator Muskie makes a proposition for both equalizing general support aid and a federal bonus for state income tax collections (to amount to approximately \$5 billion and \$1 billion respectively in the first full year.)[2] The goal of equalization under the general support aid is clearly stated: "Revenue sharing is needed because the distribution of income and wealth varies so widely throughout the country . . . ." (8, 2).

Considerations of equity, as well as efficiency, are always paramount in the evaluation of a fiscal measure. Thus, the current concern with equalization may be, at least in part, on equity grounds. At any rate, it appears that in pursuit of equalization we have tended to neglect the issue of economic efficiency.

## II

Historically, the people in the United States and most developed nations have been accustomed to the notion of interpersonal equalization. Notable among measures intended for such equalization are progressive income taxes. Although progressive taxation has had great hurdles on its path, theoretical or otherwise, the system has been with us for decades and once the general notion of equalization is accepted, the question of whether the equalization involves <u>persons</u> or <u>areas</u> may not seem pertinent. It is important, however, that we draw a distinction between <u>interpersonal</u> and <u>interarea</u> equalization.

The question of equity involves people and if an interarea equalization is to be rationalized on the ground of equity, the ultimate objective of such an equalization must somehow be linked to persons. A basic question to be asked then is whether interarea equalization is meant to be an additional, if indirect, measure for interpersonal equalization. If it is, one can argue that

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the equalization under revenue sharing is not an efficient way of achieving the goal. This follows as long as equalizing transfers which favor low-income areas (or states) do not discriminate between the rich and the poor within each low-income area. Given the objective, the more effective approach may be found in the program which reach the individuals directly in such measures as negative income tax, minimum income allowance, or categorical grants aimed specifically for the poor.

It was suggested that in administering the general revenue sharing the federal government could "broadly restrict use of the funds to education, health, and welfare, and community development programs," (10). Benefits from these services may be greater for low-income people but one wonders how effective such restrictions can be as the states shift their own funds from these restricted areas to other uses.

III

Although recent literature on revenue sharing has little to say on the question of resource allocation, a brief, but lively, debate on the issue did take place in the early fifties. Thus, A. D. Scott, emphasizing the long-run implications of equalizing unconditional grants, argues that in the interest of economic efficiency (maximizing national production) a situation must prevail where "resources and labor are combined in such a way that the marginal product of similar units of labor is the same in all places. . . ." (14). He maintains that equalizing grants, by providing amenities to the poor people in resource poor states, may frustrate an important equilibrating force which exists in a competitive economy, namely the mobility of labor.[3]

One may reason with Buchanan (6) that equalizing grants, by increasing public capital and attracting private capital in poor regions, tend to increase the efficiency and the income of labor in these regions.[4] That certain public investment is conducive to private investment, however, would not be limited to poor areas. Prosperous high income areas which experience increasing private investment and population would require a corresponding increase in public investment, a complement to the private sector activities. While for low-income areas the private investments which may follow public investments are no more a possibility or a probability, for those areas which currently experience growth in economic activities and population, the need for additional public investment is real and imminent. This would seem to have some implications with regard to the respective marginal productivities of the limited public funds invested in low- and high-income areas.[5] It is not to argue that there ought to be a reverse redistribution in favor of high-income areas, but to suggest that considerations of allocative efficiency alone cannot be a generally tenable justification for equalizing unconditional grants.

What appears to be separate emphases on labor mobility and on capital mobility is not to be constructed as stemming from their incompatibility. One can conceive of situations where measures to improve labor mobility enable capital resources to move more readily to deserving areas. While capital and business establishments are responsive to new opportunities, labor for various reasons--financial, uncertainty, lack of information, emotional, etc. --tends to be less mobile. This would create a labor surplus for a declining area, but it may be the type that does not meet the need of the firms which might potentially be attracted to new opportunities in the area. If fact, it could be a liability, since taxes to be borne by the incoming business would have to be greater to the extent that the latter help support the unemployed residents. Thus, the area in question may be unable to take advantage of an opportunity because of (not inspite of) the "surplus" labor. To better enable a low-income area to exploit its economic potential, then, proper policy would have to include measures to improve labor mobility.

Improving labor mobility is certainly not an appropriate answer in all cases. It would be without economic rationale if, for instance, the costs involved in the programs outweigh the benefits. To be included in the costs are possible losses in private and public overhead capital associated with migration as well as possible adverse externalities and diseconomies of agglomeration and urbanization. Thus, in some cases, appropriate plans for public investment to improve the conditions of the poor regions may promote rather than hinder efficiency for the country as a whole. Such programs, however, are more properly in the domain of specific aids rather than an equalizing general grant. Causes for decline vary by area and variable measures to cope directly with the problems of the respective areas would be more effective than equalizing general grants. Moreover, in areas where the problems are more deep rooted, the costs of the program, specific aid or otherwise, may far outweigh the potential economic gains from the investment. Thus, where neither mobility improving programs nor plans for other public investment can be justified on the ground of allocative efficiency, appropriate policy to pursue ought to involve welfare programs guided by distributional considerations.[6]

Equalizing transfers may be defended on the presupposition that the grant funds are likely to be expended on education, health, and welfare in large part and these are the types of services which tend to encourage labor mobility (5). There are questions as to what portion of the grant funds will actually be channeled into these uses,[7] and whether these specific public services can best serve the interest of a state (or a community) when they involve programs stimulating migration. In any event, if mobility improvement is what we are after, there seems to be more direct and effective ways of achieving this objective.[8]

It has been widely believed that interstate tax competition and fears of losing industry and wealth inhibit state-local tax efforts. The situation leads to a resource underutilization in the subfederal public sector, but the remedy does not call for an equalizing general grant as some would suggest (11, 126). Under a general grant, an increase in state and local services may be realized through an income effect. However, what is needed to correct the resource malallocation suggested here is a substitution effect involving changes in the relative price of the public services.[9] The latter effect can be brought about by such measures as a federal tax credit of state and local taxes or categorical matching grants. Both measures would lower the effective price of the public services, the differences being that the matching grants specifies the items of the services to increase while the tax credits do away with the specificity.

Some advocates of revenue sharing argue that once poverty takes firm hold on a community it will tend to perpetuate and accentuate itself independently of underlying economic potential of the community (5, 145). This view may seem parallel to the classic argument of "vicious circle of poverty" as related to underdeveloped economies, but there is one important aspect which differentiates the former from the latter, i. e., absense of artificial barriers to the flow of capital, entrepreneurial and technological know-how among nations. In the framework of general equilibrium and a free enterprise system, opportunities of all kinds are constantly weighted against one another, and if the underlying economic potentials, new or old, are considered worth exploiting, forces exist within a national economy that are responsive to these opportunities. An economic potential, it may be noted, is to be identified not with a single economic factor but with composite factors which include the general welfare posture of the community as well as such other aspects as the proximity to the markets (of labor and products) and to the sources of materials, the transportation network, etc. Measures undertaken to alleviate the dire poverty of a community may fail to bring about a new life to its economy for other reasons. Should further steps to improve these other aspects be called for, the economic basis for action ought not to be the mere absence of industry or the like but our best assessment of the potential gains expected from the investment involved.

Our concern for allocative efficiency is not inconsistent with distributional considerations. Operating in a maximum efficiency, the economy will be more capable of supporting the programs aiding the poor. Equalizing general grants entails a risk of perpetuating inefficiencies. When the program involves a relatively small amount at the outset, the effect may be minimal. But, as it grows and becomes gradually entrenched into the system, we may face a serious question of allocative efficiency at a time when shifting to an alternative approach is more difficult.

## FOOTNOTES

[1]Under the Commission proposal, the taxpayer would be allowed to credit against his Federal income tax liability a certain percentage of his state income tax payments. See Advisroy Commission (2).

[2]The bill (S 1770) proposes establishing a fund for general support aid (to comprise 1.3 percent of aggregate taxable income on the federal individual income tax returns) and for a 10-percent bonus for state income tax collections. See Congressional Record (8).

[3]The same point was made earlier by Joseph P. Harris: "Communities which cannot economically support themselves should not be artifically maintained by government subsidy. The principle of distribution in proportion to financial abilities should never go to the length of retarding the normal and necessary readjustments in population." See Harris (9) and Adarkar (1).

[4]For subsequent exchanges between Scott and Buchanan, see (16), (7).

[5]One should not, of course, overlook externalities, the economies and diseconomies of agglomeration and urbanization. Consideration of these aspects, however, would not be expected to invalidate the basic argument concerning the opportunity cost.

[6]If welfare programs are to incur a greater cost relative to the programs for improving labor mobility and/or other public investment, the latter programs may still be justified and preferable even if the costs exceed the benefits, provided that these programs can largely eliminate the need for the more costly alternative, the welfare programs.

[7]Some studies project that the greatest precentage change in states' expenditure patterns will occur in housing and urban renewal. According to one study, such expenditures will grow at a rate nearly five times the change in educational expenditures. Actual increase in the years 1957-1963 was 9.3 percent for education as compared to 16.3 percent for housing and renewal. See Netzer (14).

[8]It has also been suggested that the improvement of education facilities and better educated labor force help attract potential investors. But here again, the question of the opportunity cost inevitably arises. Granted that the relative returns to the public funds involved are such that equalizing transfers expended on education are justified, it only offers a basis for supporting a categorical aid.

[9]See (17), (4) for related discussions.

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