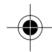

Dwight R. Lee

The Case for Fiscal Federalism

Two unmistakable problems plague our political economy. First, political power has become too centralized, with the federal government taking over more and more functions that, if the responsibility of government at all, are the responsibility of local governments. Second, the federal tax system has become so complicated, and so subject to political churning, that it is imposing outrageous compliance costs on taxpayers and permeating the economy with tax-induced distortions.

The problems of excessive political centralization and an overly burdensome tax system were instrumental in the Republican takeover of Congress in November 1994, and have motivated calls for political reform. The devolution of government functions back to the states and reforming the federal tax system are currently hot topics among those who see the need to rein in the excesses of the federal government. Unfortunately, devolution and tax reform are being considered separately. They shouldn't be. Devolution will be all sound and no substance without serious tax reform, but there can be no serious tax reform unless the power to tax is also transferred to the states.

As long as the federal government maintains its dominant authority to tax, it will control far too many state and local functions.[1] When people have to pay most of their taxes to the federal government, state authorities must follow orders from Washington if they want to retrieve some of their constituents' federal tax dollars. And any cockamamie project that appeals to inside-the-Beltway bureaucrats will be embraced by state officials as a way of recapturing tax dollars.

Also, attempting to reduce the distortions in the economy with a flat-rate tax, or a consumption tax (both of which hope to promote efficiency by closing tax loopholes), is likely to increase distortions unless the authority to tax is first shifted to the state level. At the federal level, such reforms would allow the government to capture more revenue and increase the worst of all tax distortions, a further expansion of the public sector at the expense of the private sector.

After discussing some problems of political centralization, I present a proposal for addressing these problems by radically decentralizing the power to tax. My proposal calls for a real return to fiscal federalism by abolishing federal taxation altogether.

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The case for abolishing federal taxation is strong. Indeed, the strength of the case guarantees that it will be dismissed by those whose interests and visions are tied to the inefficiencies of the status quo. But by boldly making the case for eliminating federal taxation, I highlight the futility of reform that is limited to making marginal changes in existing arrangements.

The overriding consideration in the fiscal relationship between the state and federal governments is that most of the country's tax base has been taken over by the federal government. In 1929, total government receipts were $11 billion and total federal government receipts were $3.8 billion—the federal government took in 34.5 percent of all government receipts.[2] In 1991, total government receipts were $1,746.8 billion and total federal government receipts were $1122.2—the federal government took in 64.2 percent of all government receipts.[3] The transfer of fiscal control from the states to the federal government is seen to be even more pronounced when we consider expenditures, which are a better measure of taxation than receipts. In 1929, federal government expenditures were $2.7 billion out of $10 billion in total government expenditures, or 27 percent.[4] In 1991, federal government expenditures were $1332.7 billion out of $1940.1 in total government expenditures, or 68.7 percent.[5]

Having taken control over most of the dollars paid by taxpayers, federal authorities are in a position to return some of those dollars to the states to fund what they consider worthwhile projects. In this situation it is almost impossible for politicians and government authorities to be fiscally responsible. Even if politicians wanted to keep taxes low, support only essential government projects, and implement those projects at least cost, they would be foolish to do so under existing fiscal arrangements. Fiscally responsible behavior by a politician is currently equivalent to political suicide.

Every politician except the President represents a local constituency that sends most of its tax dollars to Washington D.C., and wants its political representatives to get back as much of that money as possible. Taxpayers realize that if they don't recapture some of their money for local projects, the federal government won't take less of their money. They will continue to pay just as much federal tax as before, and their money will simply be given to others. Everyone acknowledges that it would be better to use federal tax money wisely, but people also realize that if they don't waste available tax dollars, others will. So spending proposals don't have to make economic sense (be worth more than they cost) to make political sense, and to be enthusiastically sought after by local officials. Inefficient proposals that appeal to federal politicians and bureaucrats because they expand their perks and power will be seized upon by local representatives as means of securing federal funds that would otherwise be squandered by others.

Many wasteful federal projects are eagerly sought after by state governments. Mass transit projects, water diversion projects, urban renewal projects (now called empowerment zones), public housing projects, and the cleaning up of Superfund sites are just a few of the federally funded programs that could seldom, if ever, pass an economic benefit-cost test, but which easily pass muster in a political benefit-cost comparison.

The problem is not just that wasteful projects are funded by the federal government, but that many are not properly federal concerns. Projects that benefit primarily local constituents, even if they are economically efficient, should be funded locally. Local funding of local projects is called

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for on both equity and efficiency considerations. Why should the widow who lives in Round Up, Montana, be required to pay for a fixed rail transit system for San Diego, California? And local funding greatly reduces the likelihood that projects that aren't worth what they cost will be funded, and increases the likelihood that those that are funded will be funded efficiently. The problem here is illustrated by a story related by David Stockman, former Director of the Office of Management and Budget.[6] Two elaborate tennis courts were built with federal funds near Stockman's family farm in Michigan even though there were few, if any, tennis players in the area. Local officials were happy to receive the money since they could claim they were effective at securing federal funding to create local jobs (which were in fact created when the tennis courts were constructed). But the two courts went almost completely unused and were not maintained. Obviously these tennis courts were not worth constructing, and would not have been if only local funding had been involved.

Tennis courts near the Stockman farm represent a small drop in the wide river of federally funded projects that, if worth funding at all, should be funded with local tax dollars. Just what is the justification for the federal government to provide $1.08 million for an indoor baseball field in Huntsville, Alabama; $5.3 million for a baseball and soccer park in Jonesboro, Arkansas; $1.3 million for three bike paths in Modesto, California; $28 thousand to resurface tennis courts in Evanston, Illinois; $800,000 for research on a bike path in Eugene, Oregon; and $1 million for three swimming pools in Midland, Texas?[7] There is no principled justification for federal funding of these projects, and the thousands of other similar projects in every nook and cranny of the country. There is only an explanation: that the fiscal relationship between the state and federal government is an invitation to waste.

While recognizing the waste that results from transferring so much of the nation's wealth from the states to Washington, and then back again, one might argue that more federal funding does at least lower state taxes. But does it? We can never know, of course, what state tax burdens would be in the counter-factual world in which the federal tax burden had remained at the 1929 level. But consider that in 1929, when federal government revenues were 3.7 percent of Gross Domestic Product, state and local revenues were 7.0 percent of GDP. In 1991, when federal government revenues were 19.6 percent of GDP, state and local revenues were 10.9 percent. There are reasons for believing that increasing the federal tax burden puts upward pressure on state tax burdens as well.

First, the more money the states send to Washington, the more they spend in the competition with each other to retrieve as much as possible. State governments are full of agencies that spend much of their state-funded budgets lobbying federal agencies in efforts to secure funding for local programs. It is difficult to know exactly how much of a state agency's budget should be counted as lobbying for federal dollars, but for many agencies it is substantial, and it increases with the amount of federal dollars available. The states find themselves in much the same situation in which I occasionally put my students to illustrate the concept of rent seeking. I tell them I am auctioning off a $100 bill to the highest bidder with the understanding that each of them has to pay what he bids whether it is the winning bid or not. Interestingly, I often receive bids that total more than $100, suggesting the possibility that collectively states spend more trying to capture federal money than they receive.[8] This probably isn't the case, no

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doubt because state and federal officials, and organized interest groups, find advantage in more cooperation (often at the expense of the unorganized taxpayers) than my classroom game allows. On the other hand, my students are not having to bid to get their own money back. And they can without penalty choose not to play the game. This is a better situation than states find themselves in, since they are bidding for their own (more accurately, their citizens') money, which means that dropping out of the game unilaterally is not a sensible option.

Second, when a state does secure federal revenues for a local project or program, it is usually obliged to pick up at least part of the costs. One can argue that the state must believe the benefits from the project are worth as much as the additional cost it is required to pay. This is almost surely true for politically organized interests whose members benefit directly from the project, typically through employment opportunities, but it is not necessarily true for the general taxpayer who benefits from the project only as a consumer and whose taxes pay the additional state cost required. But even if the benefits to the general citizen in the state from the federally funded project are worth more than the additional state cost, the federal funding comes with upward pressure on state taxes.

Third, the more money that goes from the states to Washington, and then back to the states, the more it is bundled in costly bureaucratic demands. The federal government seldom transfers money back to the states without attaching a host of restrictions and requirements. Federal aid to education, though amounting to only about 8 percent of the total amount states spend on education, comes with numerous requirements on the curriculum, funding, and management of local schools. These requirements have increased the amount that the states have to spend on schools and have reduced the education that takes place in those schools. Often federal grants to the states come with costly restrictions and threats largely unrelated to the purpose of grants. For example, the federal government has threatened to cut off highway funds to states which do not quickly implement federal mandates designed to make voter registration easier (by, for example, allowing welfare recipients to register to vote when applying for welfare).

Fourth, the greater the percentage of our tax dollars controlled at the federal level, the less discipline there is at all levels on the power to tax. So transferring more power to tax to the federal government can actually enhance the power of state governments to tax. The larger the percentage of the total tax bill the central government imposes, the less significant the differences in state taxes to the overall tax burden of each taxpayer. The reduction in the tax advantage realized from locating in one political jurisdiction relative to another reduces the tax competition between those jurisdictions. The greater the federal government's power to tax, the more effectively it can enforce what is best described as a tax cartel that allows all levels of government to charge more for their services (see McKenzie and Staaf, 1978). Indeed, under the formal revenue-sharing program of the 1970s and early 1980s, the federal government encouraged state governments to tax aggressively with revenue-allocation formulas favoring states that scored high on "tax effort." The proposition that centralizing the power to tax increases the revenue available to government is not just theoretically plausible, it is also supported by empirical evidence (see Martin and Schmidt, 1983).

But even if centralizing the power of the federal government to tax does not increase state taxes, it does increase the ability of special-interest groups to expand the tax

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burden imposed by government in general. Consider a geographically concentrated interest group benefiting from government transfers. Moving the funding of these benefits from the state government to the federal government spreads the costs over a much larger population. This reduces the per-capita cost of the resulting taxes, which increases the difficulty of motivating political resistance to the special interest's demands. Also, federal control reduces the political transaction costs faced by interest groups. It is easier to master control of a few centrally located special-interest levers than to deal with a multitude of such levers spread over different government levels and jurisdictions.

As the federal government has grown, the federal tax system has become an ever more complicated source of economic distortion. It is increasingly difficult for taxpayers to know what they are paying in taxes for government activities, and at the same time tax considerations are having more influence on economic choices than wealth considerations. Not surprisingly, people concerned about the disruptions and inefficiencies federal taxes are imposing on the economy are advocating tax reform at the federal level. Proposals for replacing the current federal income tax with a flat-rate tax (Dick Armey; R-TX) or a national sales tax (Bill Archer; R-TX) are now being discussed. We can hope that a national discussion of these taxes is a prelude to something more useful than tinkering around the edges of the existing tax system. But the question raised by the current discussion on federal tax reform is: What is the best tax system for the United States? And the honest answer is that nobody knows what the best tax is. Indeed, there isn't one for the entire country. The best tax system for Texas is not likely to be the best tax system for New York, or Oregon, or Nevada. And even more important, the efficiency case for a flat-rate tax, or a sales tax, suggests that implementing these taxes at the federal level carries serious risks not present at the state level.

Consider the efficiency argument for a flat-rate tax. By lowering the marginal tax rate on income and eliminating most categories of nontaxable income, the tax system does less to distort economic decisions. Lowering marginal rates and closing off loopholes would reduce both the incentive and the opportunity to make decisions aimed at avoiding taxes rather than producing wealth. So no doubt a flat-rate tax would reduce the economic inefficiency per dollar raised. The problem is that, at the federal level, a flatrate tax would provide an irresistible temptation to raise more tax revenue. With the loopholes closed, a large increase in additional tax revenue could be obtained with small increases in the tax rate. And surely strong arguments will be made for doing exactly that, with the benefits "urgently" needed and highly visible and the costs thinly spread (even more thinly with a flat-rate tax) over the politically unorganized. The distortion caused by the actual transfer of each dollar to the federal government will be less, but the distortion caused by expanding the federal government's control over the nation's wealth will be greater. While it is possible that the net effect of a move to a flat-rate tax at the federal level is greater efficiency, the potential gains are not as great as many seem to believe, and may well be negative.[9]

Another cause of tax inefficiency is the constant churning of the tax code. The old saying that "the best tax is an old tax" is based on the wise observation that a stable tax structure allows people to make the long-run commitments and plans that economic progress requires without the cost of artificially created uncertainty. A stable inefficient tax can be more efficient than a

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endless series of different efficient taxes. And a flat-rate tax on income at the federal level will not long remain stable.[10] As the rate (or rates) increases (and almost surely new rates would creep in—as they have since the 1986 tax reform) the value of exemptions to taxable income would also increase. Loopholes would command a higher price in the political marketplace, creating political profit opportunities that politicians will not ignore. So, given the relentless special-interest pressures for more government spending under the current centralized political regime, even if we begin with a flat-rate tax it would soon mutate back into a progressive, high-marginal-rate structure, permeated with loopholes.

A similar prognosis applies to a federal sales tax. Efficiency arguments can be made for a sales tax. Unfortunately, the experience in Europe suggests that national sales taxes soon become national value-added taxes, which are virtual money machines for central governments. To paraphrase Ross Perot, that giant sucking sound you hear is the nation's wealth being pulled into the public sector. Undergirding the argument that a flat-rate tax or a national sales tax would be efficient is the belief (typically unstated) that the government has a fixed requirement for the efficient amount of revenue and will not exploit opportunities to seize revenue beyond that requirement. Who can seriously believe that federal government is subject to such discipline?

As long as most of the power to tax resides in Washington we will never have anything more than the pretense of authority at the state level, all the talk of devolution notwithstanding. And neither will we ever have serious tax reform. The advantage in the devolution of government functions is that each state would have more latitude to choose what is best for it rather than being forced into one-size-fits-all programs and approaches mandated by remote authorities. States could also become economic laboratories, each discovering what works and what doesn't through a trial-and-error process that is not smothered by centralized political power. These are the advantages of federalism. Such advantages are just as clear when one considers the means of financing government functions as when one considers the functions themselves. Indeed without fiscal federalism there can be no genuine federalism. So I now consider a proposal for serious devolution, the devolution of the power to tax. This proposal would create a fiscal federalism consistent with the type of political process the framers of the U. S. Constitution envisioned: a political arrangement in which the state governments employ a subordinate federal government to provide a few services benefiting all the states but which no one state would see advantage in providing alone (such as national defense). Most government services would be provided efficiently at the state level, and provided only when they are legitimate public concerns.

Under my proposal, which I call reverse revenue sharing, the federal government has no power to tax. All power to tax resides within the states. Such an arrangement harkens back to the fiscal federalism established by the Articles of Confederation, which served as a compact among the states during the Revolutionary War (although it was not officially adopted until March 1781) and was replaced by the United States Constitution in 1789. Despite popular opinion, the most serious problem under the Articles of Confederation was not the lack of an independent power to tax by the federal government. The real problem was that the states were under no legal obligation to share their tax revenues with the federal government. So each state faced a strong temptation to free ride on the contributions of other states

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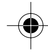

to federal activities that provided general benefits—such as carrying out the war against Britain. My reverse-revenue-sharing proposal eliminates this free-rider problem by requiring that each state share a proportion of the tax revenue it raises (say 30 percent) with the federal government, with the proportion being uniform over all states.

Decentralizing the power to tax with reverse revenue sharing overcomes many of the problems caused by the current, highly centralized fiscal arrangement. Political incentives would be altered to discourage all but the provision of national services at the federal level, to encourage the least-cost provision of government services at all levels, to increase the discipline on government that only competition can impose, to promote the responsible use of efficient taxes, and to rein in the political influence of organized interest groups. Let's consider these advantages in detail.

Under reverse revenue sharing the federal government's control over how much money it receives would be significantly diminished. It would still have some control over receipts, but exercising that control would require productive rather than destructive policies. Federal authorities could no longer raise additional money by increasing tax rates. The federal government could obtain more revenues only indirectly by focusing its expenditure on the efficient provision of services that improve the general productivity of the country, but which no state would finance unilaterally.

Related to the motivation for the federal government to efficiently provide truly national services to the states is an equally powerful motivation not to finance projects that benefit primarily state and local constituents. For the federal government to finance such projects would undermine its only source of revenue by relieving state and local governments of the need to raise revenue.

Governors and mayors might remain anxious for federal funding of bicycle paths, tennis courts, and swimming pools, but they would soon learn that lobbying for such funding was futile, given the resistance of federal officials and the limits of the federal budget. No policy would do more than reverse revenue sharing to bring the curtain down on the pork-barrel politics that has the federal government involved in far too many state and local concerns.

If a local function was worth doing, the state governments, having to finance the function out of state taxes, would have an incentive to do so efficiently. This incentive would be strengthened by the sharing requirement in my proposal. Under current fiscal arrangements, with state governments receiving much of their revenue from the federal government, state authorities and their special-interest constituents can benefit as free riders by spending tax money on local projects that are worth less than they cost. And the more the cost of the projects, the bigger the free ride. Under reverse revenue sharing, with the federal government limiting its expenditures to providing general benefits to all states, each state would recognize that its federal benefits would be largely independent of its contribution to federal revenues. A state could free ride under reverse revenue sharing only by reducing its federal contribution, which can be done without reducing services to its citizens only by providing those services more efficiently. The desire to free ride on the contributions of other states is converted into a powerful force for government efficiency. It is hard to imagine a policy doing more to motivate the privatization of government services than reverse revenue sharing.

Reverse revenue sharing would also pro-

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mote efficiency in government spending by enhancing political competition among the states. States that didn't provide important government services, and provide them efficiently (or that provided extraneous services whether efficiently or not), would find their shortcomings highlighted. Having to pay for state services with state taxes, an inefficient state would, relative to the services provided, be a high-tax state. And a high-tax state, no longer able to obscure its competitive disadvantage under a heavy overlay of federal taxation, would find its tax base being competed away by states more responsive to the interests of its citizens.

The fiscal competition intensified by reverse revenue sharing would also improve taxation by making efficient taxes really efficient. There would no longer be a tax cartel administered and enforced by the federal government. The federal Internal Revenue Service (IRS) would be replaced by 50 competing tax systems. A big help in allowing a state to compete effectively for a growing tax base would be to adopt a tax system that, given its local situation and circumstance, is efficient (in the sense that it minimizes economic distortions per dollar raised). But an efficient tax system would not make a state more competitive if its tax system were exploited to expand public sector output at the expense of more valuable private sector output. So "efficient" taxes such as a flat-rate tax, a consumption tax, or a VAT that would be a vehicle for inefficiency at the federal level, would really be efficient taxes when they were administered at the state level in response to competitive pressures of genuine fiscal federalism.

Finally, reverse revenue sharing would go a long way to counter a major force behind government growth and inefficiency: i.e., the political influence of organized interest groups. By confining taxing power to the states, and therefore concentrating the burden of any decision to increase taxes on fewer taxpayers, reverse revenue sharing would bring the political costs of spending proposals more in line with the social costs. Those who pay for government programs would have more motivation and ability to respond politically to the costs of those programs. But even at the state level, organized interest groups can communicate the benefits they receive from spending programs better than taxpayers can communicate the costs they pay. If each tax dollar raised by a state government could be spent on constituent groups within that state, the tendency for government to tax and spend beyond efficient levels would remain strong. This tendency is reduced by reverse revenue sharing since local taxpayers pay more than local interest groups receive, thereby increasing taxpayer motivation to oppose taxes relative to special-interest motivation to champion them. Indeed, reverse revenue sharing could make opposition to taxes the dominant political influence. In the extreme case, for example, with the state governments required to transfer 100 percent of the revenue raised to the federal government, organized interests within states would have no motivation to lobby for taxes on local constituents. This case is not recommended, but it does point to the discipline special-interest groups would be subjected to under reverse revenue sharing.

I am not talking about reform that can be realized by having Congress pass some legislation. I am talking about serious reform, the type that has to be imposed on reluctant politicians. Reverse revenue sharing would require an amendment to the Constitution. And, of course, the elites in Washington will be quick to tell us that we shouldn't be tampering with the Constitution. Of course, they (the politicians, bureaucrats, and courts) have been tampering with the Con-

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stitution for years by ignoring clear constitutional limits (e.g., the 10th Amendment) when they find it convenient. Tampering with the Constitution seems to be quite acceptable as long as it concentrates more power in the hands of political authorities and their minions. We need to begin reducing the control of remote authorities over our lives and our economy with some reverse Constitutional tampering. Term limits and a balanced budget amendment would be a good start. But to really change the rules of the political game to convert our public servants back into our servants rather than our masters, few reforms would do the job as effectively as reverse revenue sharing.

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Notes

1. To simplify the exposition I will refer to state government even though I may have both state and local governments in mind. **2.** Data taken from U. S. Department of Commerce, Bureau of Economic Analysis, *National Income and Product Accounts of the United States.* Volume 1, 1929-58 (Washington, D.C.: U.S. Government Printing Office, Feb., 1993), Tables 3.1 (p. 55) and 3.2 (p.56). **3.** Data taken from U. S. Department of Commerce, *Survey of Current Business* (Office of Economics, July 1992), Tables 3.1 and 3.2, p. 66. **4.** Expenditure data from the same tables cited in footnote 2. **5.** Expenditure data from the some tables cited in footnote 3. These expenditure figures surely understate the real shift in fiscal control from the states to the federal government because of the increased control federal authorities exert over state spending. **6.** As told in Greider (1982). **7.** These projects are taken from a larger list from the editorial, "Pork Carry Out," in the *Wall Street Journal,* April 5, 1993. The *Wall Street Journal* list was taken from a list of over 4,000 projects that Henry Cisneros, Secretary of Housing and Urban Development, said the Clinton Administration would work from if the $16.2 billion "stimulus" bill had passed. The bill didn't pass, but many of these projects were funded anyway. **8.** I want to quickly point out that I do not actually keep the money that is bid, so I am not profiting at the expense of my students. Of course, I don't shell out the $100 payoff either. It should be pointed out that the observation that more may be bid in rent-seeking games than is returned is supported by theoretical considerations. See Tullock (1980). **9.** The risk in making the tax system more efficient is considered in depth by Brennan and Buchanan (1980) with a model of leviathan government. Under assumptions that many see as not unrealistic, Brennan and Buchanan show that making the tax system more efficient (as prescribed by traditional public finance specialists) results in less overall efficiency as government exploits the increased "efficiency" to expand at the expense of the private sector. **10.** It should be admitted, however, that this is not much a criticism of a flatrate tax since the current federal income tax is constantly being changed by Congress. **11.** The 10th Amendment is extremely relevant to the discussion here since if it were being honored many of the problems that would be addressed by my reverse revenue sharing proposal would never have materialized in the first place. The 10th Amendment reads, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." But other provisions in the Constitution have also been largely ignored: e.g., the restrictions on taking private property for public use without just compensation. And powers for the federal government that were never intended by the framers have to be read into the Constitution; e.g. interpreting the Commerce clause (Section 8, No. 3) as granting the federal government the power to regulate a host of activities that have nothing to do with interstate commerce.

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