Reverse Revenue Sharing: A Return to Fiscal Federalism

Dwight R. Lee

The federal government has assumed so many responsibilities for so many diverse problems that it no longer has the ability to do anything well. The real cause of gridlock in Washington is not the system of checks and balances that restrains the activity of government, but the lack of restraint on a federal government that is accomplishing so little because it is attempting so much. This gridlock will not be reduced by one-party rule in the nation's capital. The opposite is more likely the case. Unless the federal government concentrates on the few things that need to be done collectively, and can only be properly done centrally, the gridlock of inefficiency will remain the hallmark of Washington. But any attempt to prune the activities of the federal government will meet head on with another hallmark of the nation's capital, entrenched special interests. Every federal program, no matter how inappropriate its purpose as a federal responsibility or how counter-productive in achieving that purpose, is championed by an organized interest group that benefits not just from the existence of the program but also from having it controlled and financed from Washington. Any attempt to eliminate a federal program, or shift responsibility for it to the state or local level, is sure to be frustrated by intense special-interest opposition.

Overcoming special-interest influence, and reversing the proliferation of federal activities supported by that influence, though difficult, is not impossible. But it will take fundamental reform of the political environment that has provided such a fertile habitat for organized interest groups. You don't overcome the alligators by fighting them one at a time; you do so by draining the swamp. And the reform necessary to drain the political swamp and rein in the power of the

Cato Journal, Vol. 14, No. 1 (Spring/Summer 1994).

The author is the Ramsey Professor of Economics at the University of Georgia.

organized interest groups involves restoring true fiscal federalism, a restoration that can only be achieved by a dramatic decentralization in the power to tax.

I have in mind a return to a modified version of the fiscal arrangement contained in the Articles of Confederation in which all power to tax resided within the state governments, with the federal government relying on the states for the revenue to support its activities. The flaw in this arrangement was that each state faced the temptation to free ride on other states' contributions to the federal government. While this flaw dominates the general perception of the Articles of Confederation as unworkable, it is easily corrected. Rarely considered are the advantages realized when the power to tax is as decentralized as it was under the Articles of Confederation. These advantages include reducing the influence of special interests on political decisions, increasing the accountability of government at all levels, and motivating a more rational assignment of responsibility for government functions between the federal, state, and local levels of government.

To best appreciate the advantages of decentralizing the power to tax, consider first the persistent pressures toward greater political centralization.

The Politics of Centralization

The ideal of democracy may be the dispersion of power, but the tendency in democracies is the centralization of power; in politics centripetal forces dominate centrifugal forces. Governments in the major industrialized countries have, almost without exception, become more centralized during the twentieth century (see Vaubel 1992). The United States is no exception. In 1929 the federal government collected approximately one-third of all government receipts in the United States and accounted for slightly more than one-fourth of total government expenditures. Currently the federal government collects almost two-thirds of all government receipts in the United States and accounts for almost 70 percent of total government expenditures. As the federal share of government revenues and expenditures increased, so did the relative size of government in total. In 1929 total government spending was approximately 10 percent of national income. Currently total government spending is over one-third of national income.

One explanation for the increased centralization of government is that it is required for government to perform more efficiently. Supposedly, as problems become increasingly complicated and people become increasingly mobile, more of the services demanded of government generate benefits that extend beyond the boundaries of state and local governments. Education, public health, environmental protection, and poverty relief are commonly cited examples. State and local governments will fund such services below levels that are efficient since the constituency in each recognizes that (1) its contribution would be of little consequence, and (2) it can free ride on the contribution of others. The explanation is typically accompanied with the argument that the federal government, with its wider constituency, is in the best position to use its power to tax to insure the adequate supply of otherwise unprovided services by either supplying them directly or providing revenue to state and local governments for the purpose of supplying them. In other words, government becomes more centralized because it is efficient for it to do so (see Oates 1972).

This efficiency-enhancing explanation for government centralization would have credibility if government decisionmakers possessed the information and motivation necessary to determine and promote some common vision of the public interest. Although, if this benevolent view of government were made explicit, few would embrace it, it provides the implicit rationale for many public programs and policies. A more realistic model of government consists of political decisionmakers pursuing their private objectives subject to the constraints imposed by the political process. In this private-interest model of government, political outcomes are seen to emerge out of the interaction of diverse and competing interest groups. There is no presumption of efficiency in the private-interest model of government. Efficient outcomes may or may not emerge, depending on how well the political process matches up those who realize benefits from government services and those who pay for those services.[1]

Unfortunately, relatively small and well-organized interest groups commonly obtain benefits through political action that imposes costs on the general public in the form of higher taxes and a less efficient economy. The ability and motivation of such interest groups to take political action is seldom countered by those paying the bill because their numbers are so large and their individual stakes are so low. When considering an explanation for political centralization within the private-interest model of government, one has to examine how organized interest groups (those with the most to gain from political action) benefit from that centralization. For several reasons politically influential interest groups stand to benefit when the federal government's control over taxing, and therefore spending, is increased.

[1]The primary contribution of public choice economics has been to (1) force economists to explicitly recognize that benevolent despot models of government underlie most recommendations for public policy, and (2) provide another model of government that is consistent with the model economists use to analyse the private market.

Consider a geographically concentrated interest group benefiting from government transfers and protections. Moving the source of these benefits from the local or state government to the federal government increases the size of the exploitable population. The larger the group paying for a special interest's benefits, the lower the per-capita cost of the resulting taxes and inefficiencies, the more difficult to organize the group around a common purpose, and therefore the less the political resistance to the special interest's demands. Even if members of an organized interest group are spread over many political jurisdictions, with centralizing control over their favored government program doing nothing to increase the exploitable population, centralization can still increase the interest group's political effectiveness. The per-capita cost of the group's existing program remains the same after centralization as before. But under federal control, the cost of a targeted expansion of the special-interest benefits received by those in any one part of the country is spread over a larger public, thereby reducing political opposition to such an expansion. 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.

Politicians and government authorities at the state and local levels form influential interest groups which, one might think, would oppose increasing the political power of the federal government. But those whose interests are tied to state and local governments can realize genuine advantages from increased federal control over taxing and spending. Transferring control from state and local governments to the federal government can enhance the power, and increase the tax revenue, of all levels of government.

Consider the benefit to state and local governments when the federal government assumes more control over tax bases that have traditionally financed state and local expenditures. The larger the percentage of the total tax bill the central government imposes, the less significant the differences in state and local 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. In effect, increasing the power of the federal government to tax is a way of forming and enforcing a tax cartel, allowing the industry of government to charge more for its services (see McKenzie and Staaf 1978). The additional tax revenue can be allocated through revenue-sharing arrangements so that all government units end up securing more of the taxpayers' money. Under the formal revenue-sharing program that existed in the 1970s and into the early 1980s, the revenue-generating capacity of state and local governments was enhanced by formulas for revenue allocation that favored recipient governments which scored high on "tax effort"—i.e., continued to make good use of their own power to tax. Centralizing the power to tax increases the growth of government, a proposition that is supported by empirical evidence (see Martin and Schmidt 1983).

There is no mystery in the fact that federal officials can benefit from increasing the federal government's power to tax. Clearly those with a vested interest in expanding the agencies and programs of the federal government see advantage in more federal tax revenue. This advantage is not diminished by the fact that much of the revenue collected by the federal government is shared with state and local governments. The federal government can, and does, use the revenues it shares to buy political support for particular policies and incumbent politicians, and to induce state and local officials to provide services and demand programs that federal agencies help support and administer. By offering matching and categorical grants to state and local governments, the federal government produces a demand for federal involvement in a host of activities that should be the sole responsibility of local governments.

The greater the taxing power of the federal government, the more the political process rewards organized interest groups, and state and local governments, for demanding projects that are worth less than they cost, and the less it will reward them for implementing such projects efficiently. But regardless of the inefficiencies (and often because of them), it is in the interest of each organized group to demand more spending on its program and to push for the political centralization that amplifies that demand.

Improving on the Articles of Confederation

Returning to a governmental structure that accomplishes more while attempting less will require a clear and rational assignment of responsibilities between the different levels of government. Achieving this cannot be done by attempting to determine the details of what government should do and which levels of government should do it. The key to more responsible government is changing the political process so that it does a better job motivating political activity that promotes the interest of the general public. With the importance of political incentives in mind, I put forth my proposal for reverse revenue sharing. Although the proposal is consistent with the political traditions of federalism upon which the United States was founded, we have moved so far away from those traditions with the centralization of political power that reverse revenue sharing will now be seen as radical in the extreme. But a radical departure from the political status quo should appeal to those who want to be known as "agents of change," especially if there are compelling reasons for believing that the radical departure is a change for the better. And there are compelling reasons for believing that reverse revenue sharing would be a change for the better.

Under 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. Counter to almost universal 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 revenue with the federal government. Without this obligation, each state faced a strong temptation to free ride on other states' contributions 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 with the federal government, with the proportion being uniform over all states.

The Case for Reverse Revenue Sharing

By decentralizing the power to tax, reverse revenue sharing mitigates, if not eliminates, many problems caused by the existing, highly centralized, fiscal arrangement. Under reverse revenue sharing the political influence of organized interests would be reduced. If President Clinton is serious about controlling the special interests, he should be working to shift power out of Washington and back to the states, rather than pushing in the opposite direction. Under reverse revenue sharing the federal government would face strong incentives to confine its attention to truly national concerns. Pork-barrel projects would cease to be politically attractive. Reverse revenue sharing would motivate state and local governments to be more selective in the services they provide and more efficient in providing them. The privatization of government services would increase dramatically.

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 special interests can communicate the benefits received from spending programs better than taxpayers can communicate their costs. 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, of course, since it would result in all levels of government being underfunded by any reasonable criteria of efficiency.[2]

Next, consider the current incentives for the federal government to finance projects that are clearly local responsibilities. When state and local officials can obtain federal money, and recognize that the federal dollars they do not capture will be captured by others, local political advantage is in clamoring for federal financing of local projects that are commonly a waste of taxpayers' money and which, if they were not, would be financed locally in the absence of federal help. Consider just a few of the items that were strong candidates for federal funding under President Clinton's "stimulus" bill before it was derailed by a Republican filibuster. There was an indoor baseball field for Huntsville, Alabama, at a cost to the federal government of $1.08 million; a baseball and soccer park for Jonesboro, Arkansas, at a cost to the federal government of $5.3 million; three bike paths for Modesto, California, at a cost to the federal government of $1.3 million; expansion of the civic center in San Leandro, California, at a cost to the federal government of $12.8 million; a project to resurface tennis courts in Evanston, Illinois, at a cost to the federal government of $28 thousand; a movie theater in Columbus, Ohio, at a cost to the federal government of $2.7 million; research for a bike path in Eugene,

[2]Obviously the proportion of state tax revenue that has to be shared with the federal government can be either too small or too large from the perspective of economic efficiency. For a discussion of the efficient proportion, see Lee (1985).

Oregon, at a cost to the federal government of $800 thousand; three swimming pools in Midland, Texas, at a cost to the federal government of $1.0 million; and the list goes on.[3] Reverse revenue sharing would put an end to such pork-barrel projects.

Under reverse revenue sharing the federal government would face a strong incentive not to finance projects that provide benefits primarily to state and local constituents. The financing of such projects by the federal government would undermine its only source of revenue by relieving state and local governments of the need to raise revenue. The federal government would finance only those services that improve the general well-being of the country and the general productivity of the economy, but which no state would finance unilaterally. 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.

Reverse revenue sharing would also promote efficiency in government spending by enhancing political competition among the states. Differences in the taxing decisions of the various states would not be obscured by a heavy overlay of federal taxation. The state that increases taxes without increasing services commensurate with that increase would find its tax base being competed away by other states. Such competition would convert the ever-present temptation for state governments to free ride on the contributions of other states into a source of efficiency rather than inefficiency. With state governments currently 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 and programs worth less than they cost. 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, with it difficult for the federal government to punish a state for reducing that contribution. With reverse revenue sharing a state could free ride by reducing its federal contribution, without reducing services to its citizens, only by providing those services more efficiently. It is hard to imagine a policy doing more than reverse revenue sharing to motivate the privatization of government services.

[3]These projects come from a larger list published in the editorial "Pork Carry-Out," *Wall Street Journal*, 5 April 1993. This list came from an even larger list of over 4,000 public works projects that are contained in the National Conference of Mayors "Ready to Go" projects that Housing and Urban Development Secretary Henry Cisneros said the Clinton adminstration would have worked from had the $16.2 billion "stimulus" bill passed.

Make Governments Compete

The problems resulting from the centralization of power in the federal government, and which I have argued would be mitigated by reverse revenue sharing, have been recognized at high levels within the Clinton administration. Alice Rivlin, director of the Office of Management and Budget, argues in a recent book that the United States "cannot afford a cumbersome national government, overlapping responsibilities between the federal government and the states, and confusion over which level is in charge of specific domestic government functions" (Rivlin 1992: 30). According to Rivlin, "Washington not only has too much to do, it has taken on domestic responsibilities that would be handled better by the states" (31).

But while Rivlin sees some of the same problems with political centralization that motivates this paper, she stops well short of advocating the degree of decentralization represented by reverse revenue sharing. She sees a major problem for the states in obtaining the revenue to assume greater responsibilities because "states compete with each other" (127). Rivlin's menu of collusive arrangements for overcoming the inconveniences of this competition include—as the "most straightforward and practical" arrangement (148)—a federal tax which would be distributed to the states, and a compact of the states in which they agree "to levy and share a common tax" (149). By rejecting competition among governments, Rivlin, along with most economists (and noneconomists) implicitly buys into the view of government as a benevolent promoter of efficiency. Economists who immediately cry monopoly and call for antitrust action at the slightest evidence of increased industrial concentration applaud collusive arrangements that reduce competition between government jurisdictions. Rather than recognizing that competition is necessary to provide the information and motivation for efficiency in political activity, as in market activity, most people see competition as a constraint on government's ability to promote the public interest.

The centralization of government power that would be maintained, if not increased, by Rivlin's recommendation to limit competition among governments, would insure that her recommendation for shifting more domestic responsibilities to the states would be ignored. Government responsibilities will be assigned appropriately only in response to the pressures of a competitive process that gives those who are paying for government services more power to determine which services are provided and which government jurisdictions provide them. The case for reverse revenue sharing is that it would go a long way in creating such a competitive process.

It is true that under the competitive pressures imposed by reverse revenue sharing, some "essential" government services will be scaled back or eliminated. Any time an interest group receives benefits from expenditures that are being financed by others, one can expect those expenditures to be considered essential by the interest group. By improving the connection between those who pay for government services and those who benefit from them, reverse revenue sharing would render many government expenditures a lot less essential than they are under current arrangements. By reducing spending on government activities that cost more than they are worth, reverse revenue sharing may also reduce genuinely worthwhile government spending. Imposing accountability on spending decisions always risks passing up some desirable spending, but this is a reasonable price to pay for reducing the level of irresponsibility that characterizes so much current government spending. Also, currently worthwhile government services are not provided, or provided poorly, because they are crowded out by an avalanche of special-interest spending, or provided in the absence of competitive pressures.

Conclusion

With the proliferation of federal bureaucracies, programs, projects, and policy experts throughout the country, the federal government has become less capable of being controlled by the governed and, therefore, less capable of properly governing. The case is strong for downsizing the federal government, focusing its attention on truly national and international concerns, with government responsibility for most domestic concerns being shifted to the state and local levels. The popularity of such a shift is reflected in the ubiquitous campaign promises to return government to the people. But the political process, as currently instituted, is more responsive to narrowly focused groups than to the general public. And narrowly focused groups typically see their interests served best when political authority is exercised by the federal government.

So despite the bipartisan rhetoric in Washington in favor of getting government closer to the people, any serious proposal for doing so would be considered extremely undersirable by the politically influential. Certainly reverse revenue sharing would meet with powerful opposition if it began to be considered seriously. Precisely because reverse revenue sharing would be such a force for increased government efficiency—reducing the political influence of organized interest groups—it will fail to attract organized political support. Indeed, few things would provide more compelling evidence against reverse revenue sharing than the formation of a coalition of organized special interests in favor of it. I have confidence that the case for reverse revenue sharing is safe from this damaging prospect.

To acknowledge that a return to the fiscal federalism represented by reverse revenue sharing will not occur in response to special-interest pressures is not to dismiss the possibility of such a return. Significant political reforms are seldom, if ever, driven by the thrust of ordinary politics. But when it is widely believed that the political process is malfunctioning, and politics as usual has consistently frustrated hope for improvement, the combination of aggravated citizens, nervous politicians, and some precipitating event, or series of events, can lead to fundamental political reform. As the likelihood of such reform increases, so do the advantages of promoting discussion on reforms that hold promise for genuine improvement in the political process. With this in mind I put forth my proposal for reverse revenue sharing.

References

Lee, D.R. (1985) "Reverse Revenue Sharing: A Modest Proposal." *Public Choice* 45: 279–89.

Martin, D.T., and Schmidt, J.R. (1983) "Expenditure Effects of Metropolitan Tax Base Sharing: A Public Choice Analysis." *Public Choice* 40: 175–86.

McKenzie, R.B., and Staaf, R. (1978) "Revenue Sharing and Monopoly Government." *Public Choice* 33: 93–97.

Oates, W.C. (1972) *Fiscal Federalism.* New York, N.Y.: Harcourt Brace Jovanovich.

Rivlin, A.M. (1992) *Reviving the American Dream: The Economy, the States, and the Federal Government.* Washington D.C.: The Brookings Institution.

Vaubel, R. (1992) "The Political Economy of Centralization and the European Community." *Journal des Économistes et des Études Humaines* 3(May): 11–48.