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Revenue Sharing and Value Added Taxes

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Revenue Sharing

Generally any transfer of funds from one level of government to another to finance, or help to finance, a public service provided by the receiving government is called revenue sharing. In this paper we deal only with the sharing of federal revenue with state governments, with local governments directly, and with the local governments through the states by means of some pass-through provision.

Need for sharing

State and local revenue requirements to meet the needs for public services have been and are rising rapidly. There are a number of reasons for this including: (1) urbanization which necessitates provision of increased police protection, health services, recreation facilities, sanitation services, etc., (2) technological change which requires public facilities to make use of the technology, e.g. mass production of automobiles requires freeways, great industrial production requires pollution abatement services, (3) increasing affluence which results in demand for more and better quality public services, e.g. there is no demand for paved roads where there are no automobiles, there is little demand for public education where people must struggle to buy the biological necessities of life, (4) inflation which is more serious in the public

sector than in the private sector. This is true because much more of government expenditures are for services as opposed to goods than is the case for the private sector and the rate of growth of productivity in the production of services is much lower than it is for goods.

Despite general affluence, many states and local governments have too low per capita incomes to provide funds for financing adequate public services. Because of interstate and inter-local competition, many state and local governments which do have large per capita incomes still lack the ability to raise the revenue to finance needed public services adequately.

Local governments really have only one major tax, the property tax, which is highly regressive and very unequal in its impact on people with the same income or same property valuation. Local governments particularly are unable to tax income any more than a token amount lest they lose the base. Many will not levy any income tax even if the state permits it for fear of losing the base. While nearly all state governments do use income taxes, most of them do not rely heavily on them for fear (or pretended fear) of losing the base.

The federal government can and does levy high income taxes with little fear of losing the base. A threat of an investor to leave the country is taken less seriously than the threat to leave the state or to leave the city limits. The federal government is able to enforce tax laws more effectively and administer them more economically and fairly than either state or local governments. Even if the latter were not true, the

interstate spill-over benefits from such public services as education, welfare, and highways would make revenue sharing or having the services provided by the federal government advisable if not essential. Similarly intra-state spill-over benefits make state revenue sharing with local governments or state provision of the service desirable if not essential. Many states' governments show a reluctance to accept this responsibility. Since this is the case, it seems highly desirable to have federal revenue sharing with provision for pass-through, either mandatory or by means of approved state plans to insure that local governments are not shortchanged.

Types of revenue sharing

Revenues can be shared in a variety of ways. Some of these are listed below and some of them have already been used.

1. Direct federal operations. The federal government uses its superior taxing power to raise the funds to provide a public service which had been provided by state and local government or would otherwise have to be provided by them. Examples are mass transportation facilities or pollution control services.
2. Increasing government grants. The federal government simply provides larger grants for state and local services already partially supported. Examples are aids for education, hospitals, and interstate and federal aid roads. The federal government leaves the provision of the service to the state or local governments but coerces them into spending more on supported programs than they would wish to spend if they financed the services from purely state and local sources.

3. Straight block grants. Unconditional per capita grants are made.

4. Block grants with equalization. A large part of such grants (say 80%) might be distributed on the basis of population (possibly modified by tax effort) and a sizeable part (say 20%) might be distributed to the states with the lowest per capita incomes. Ordinarily per capita income is used to mean per capita personal income. But incomes below the poverty level have no tax-carrying ability. Most of this below poverty level income is deducted from personal income through deductible expenses and personal exemptions in arriving at federal taxable income. Perhaps a better definition of per capita income for tax purposes and as a measuring stick for calculating and comparing tax efforts is per capita federal taxable income. The extra aid given to a state with low per capita income could be weighted according to how far its per capita income is below the national average per capita income. This redistribution technique could be applied to give larger aids to, let us say, the ten states with lowest per capita incomes, or all states with per capita incomes below the national average. When aids are modified to redistribute revenue to poorer states, the modifications must be made from the richest to the poorest state if we want to avoid inequity. If we adjust the aids upward for only the 10 poorest states, we are being unfair to the state ranked 11.

5. Tax credits. The federal government encourages the states to increase their taxes or increase a specific tax by providing a tax credit against federal taxes for some percentage of specific state taxes paid. This device has been used with payroll (for employment insurance) and death taxes. The Advisory Committee on Inter-Governmental Relations recommends a 40% tax credit for state income taxes paid.
6. Shared taxes. Each state would be provided a percentage of federal income tax collections based on the federal taxes collected in the state.

All of the above types of revenue sharing result in some redistribution except No. 6, shared taxes.

Criteria for distribution of funds: general revenue sharing

The principal criterion should be population but per capita grants or shares should clearly be modified by one or more of several other criteria including: (1) personal income per capita or better still federal taxable income per capita, (2) federal income taxes paid per capita, (3) consumption (4) tax effort, i.e. state and local taxes plus charges as a percentage of personal income or (better) as a percentage of federal taxable income. An alternative measure of tax effort is the ratio of state and local tax collections plus charges to the states's potential collections (including local), defining the potential as what the collection would be if the state had the representative state tax structure and average rates. This potential would have the state use all the types of taxes in general use and levy each of them at the average rate, (5) change in the degree of

tax effort; this involves rewarding a state for increasing its effort, (6) change in the tax structure; this involves rewarding a state for making its state and local tax structure, say, more progressive or less regressive. This would reward states for increasing the relative importance of their income taxes and reducing the relative importance of sales taxes or property taxes -- especially the latter which is larger and more regressive than sales taxes.

Source of Funds

General federal revenue sharing with states might very well take its place in competition with other demands on the federal budget and federal funds whether raised by taxes or borrowing. There is no economic content in the notion that unless there is a federal surplus there is no federal revenue to share.

Since the notion that a surplus is needed to provide funds for sharing seems strongly held, perhaps a new tax, of reasonable growth elasticity and broad base, is the shortest road to sharing.

A Value Added Tax (VAT)

Multiple Stage Tax

A value added tax is a multiple stage tax as opposed, let us say, to a retail sales tax which is levied only once. Given a 3% retail sales tax a retailer would collect 3¢ for $1.00 of taxable sales. A 3% VAT would involve taxing that $1.00 a little at a time as value was added at each stage of production. The value added at the raw materials stage

might be 15¢, at the manufacturing stage 30¢, at the wholesale stage 10¢, and at the retail stage 45¢. The sum of the values added equals the value of the final product or $1.00.

A VAT can be of the gross product type, which it is if it applies to all goods and services, capital goods as well as consumers' goods. Then the collections from a 3% VAT would be the same as those from a 3% general sales tax that applied only to final sales but to capital goods and services as well as consumers' goods and services. However the incidence of the tax would be different. Some producers would find it difficult to shift much, if any, of VAT. This is particularly true for producers in areas of declining population or those in declining industries or competitive producers for national markets. This is not a desirable type of value added tax because it discriminates against capital by not allowing for depreciation.

A VAT can be of the (gross) income type if it allows producers to deduct depreciation from the value added. This version of a VAT is neutral with respect to relative treatment of capital and labor. This base equals sales minus purchases of intermediate goods (but not investment or capital goods) minus depreciation of capital.

If a value added tax is the consumption type, the base equals sales minus puchases of intermediate goods minus purchases of capital goods. This VAT with its complete exemption of capital goods is roughly the equivalent of a general retail sales tax on all consumers' goods and services -- exempting all capital goods and services.

Either the income type or consumption type of VAT can be made self-policing by using the tax credit method of collection. Each taxpayer pays a VAT equal to the tax on his gross sales minus the tax already paid by his suppliers and it is up to the taxpayer to show that his suppliers paid the tax.

European experience with VAT

Most of the European countries have a VAT. These include the common market countries, France, West Germany, Belgium, and the Netherlands (Italy is scheduled to begin VAT in January, 1972) as well as the Scandinavian countries and Great Britain. The common market countries have agreed to levy a uniform VAT of the consumption type. The tax is rebated at the border to exporters, and to prevent "unfair" competition with domestic producers, a tax equal to a local VAT is levied on imports. These border tax adjustments are made with the approval of the General Agreement for Trade and Tariffs (GATT). However, GATT rules do not allow the U.S. to rebate corporate income taxes to exporters. Thus a U.S. VAT would help in our balance of payments problem by encouraging exports.

Effects of a VAT

A value added tax might be adopted as a substitute for existing taxes such as corporate income taxes or non-luxury excises or it might be adopted as a source of new funds for revenue sharing with state and local governments or for other purposes. In a sense, a substantial revenue sharing plan financed with VAT could result in substituting VAT for a part

of property taxes. A VAT is essentially a general sales tax on all goods and services. So-called general sales taxes which exist exempt many services and some goods. A VAT bears on capital whether corporate or not, whether profitable or not and whether borrowed or not, on labor, and on land. It is "neutral" relative to the mix of the factors of production used. This is in contrast to the following:

(1) Corporate income taxes bear heavily on the income of equity capital of profitable corporations relative to the income of labor. But they do not bear on non-corporate capital nor borrowed capital (to the extent capital earnings are paid out in interest to creditors) whether corporate or not, nor on non-profitable corporate capital.

(2) Payroll taxes bear heavily on labor but not at all on capital.

(3) Property taxes bear heavily on capital investments in real (and in places tangible personal) property but not on investment in intangible such as R and D, etc.

Value added taxes affect economic growth. Since they bear less heavily on capital, there would be more saving and investment, provided overall monetary and fiscal policies were appropriate. It is widely believed that increasing the rate of saving (out of a given income) increases the amount of saving and hence the amount of investment. This is true if, and only if, the total demand is adequate to warrant the investment.

VAT collections would be less volatile than net profit taxes or income taxes. This is good for providing relatively stable though increasing funds for revenue sharing if earmarked for that purpose. It is not good for counter cyclical purposes. Rates can be changed for cyclical purposes but this sacrifices stability of yield. VAT proponents who argue that the tax is good cyclically because it is easy to change the rate cannot at the same time support it as a stable-yield tax for dependable revenue sharing.

Use of value added taxes by states

To be feasible a VAT must bear on value added where the product is produced or where it is consumed. If some countries employ the tax to bear where the product is consumed and others where it is produced, then some value added would be taxed more than once and some value added would not be taxed at all. As employed by European countries, it is made to bear where the products are consumed. Each country rebates the tax to the exporter and levies it on imports. If a national VAT is levied in this country, our place in international trade would be disadvantaged unless we made the same border tax adjustments. If a state levies a VAT, it would find interstate competition most difficult to meet because, while it would be forced by interstate competition to rebate the VAT to an exporter from the state, it could not levy an import tax on goods coming into the state because that would be an unconstitutional burden on interstate commerce.

Property taxes bear heavily on those industries which use much property in production and lightly on those which use much service but little property. A VAT is more neutral in this respect, but it bears more heavily on service producers and producers which use little property. It would appear that a VAT would provide balance. But all states _have_ heavy property taxes so industries which use much property cannot escape property taxation. No state has VAT, so if one state adopts one, some service industries can escape to other states. The service industries which could migrate, such as finance and insurance, may be especially desirable to keep. The quality of environment is not adversely affected by their growth. Interstate competition is likely to prevent a state from using a VAT successfully except at _very_ modest levels. A state's producers which pay a value added tax cannot compete at home with imports or producers who do not pay the tax -- unless the tax is small relative to freight and whatever advantages the state has in production of the goods in question.

The federal government could coerce all the states into adopting VAT, by using tax credits, but states are not permitted to tax imports from other states so the VAT would have to be based on where the value is produced. This would mean that the richer states, the industrial states, would get much revenue and the poorer states less. Much of the value added could be attributed to sales in the markets in the non-industrial states but the industrial states would get the tax revenue. For example,

let us consider an item which sells for $1.00 in a non-industrial state and that 20¢ of the value was added in that state, the other 80¢ being added in the industrial state which produced the product. Presumably most if not all of the tax rests on the consumer in the non-industrial state since the tax is, at least largely, shifted forward. However, the non-industrial state receives only 20% of the value added tax, the industrial state receiving the other 80%.

Distributing the value added revenue to where the value added is consumed would be more equitable but could hardly be accomplished with state VATS. Furthermore, even if the Constitution were amended to permit states to tax imports so that a consumption type VAT could be employed by the states and even if that did not result in an administrative mess and/or to out and out protectionism on the part of the states, state VAT would be less desirable than federal VAT to anyone who wants to redistribute tax revenues to assist the poorer states.

Federal Value Added Taxes And Using the Proceeds for Revenue Sharing

A substantial, relatively neutral VAT, could be used to relieve property taxpayers of a significant part of that relatively unneutral tax burden or, at least, stop the increase in property taxes.

VAT could substantially help in the balance of payments problem if floating the dollar doesn't solve the problem and if the 10% tariff surcharge is shortlived because of protests or retaliatory action on the part of our trading partners. European and other nations insist that the 10% surcharge is contrary to GATT.

VAT collections could be shared with the states to redistribute income using one or more of the criteria listed on p. 5 and 6 above. It should be emphasized that there is no need for permitting the method of raising revenue (whether from taxes or borrowing) or the distribution of tax liability to determine the distribution of shared revenues. Fiscal capacities are not distributed the same way needs for public services are distributed.

The Constitutionality of Current Financing of Public Education Services

The recent decision of the Supreme Court of California that property taxes cannot be used to finance schools as they have been used there (and virtually all over the country), if backed by the Supreme Court of the United States, may very well make direct or indirect federal revenue sharing mandatory with school districts, at least. The California court found that having greatly different assessed valuations of property per student in the various school districts coupled with a perverse difference of educational expenditure levels was a violation of the rights of the student in the poorly financed school under the 14th amendment. But this is an inter-state as well as intra-state matter.

A state-wide tax whether income, sales, or property could finance schools uniformly in a given state but poor states could not afford schools financed as they are in rich states. If the U.S. Supreme Court agrees with the California Supreme Court that widely unequal local property tax financing of public schools as between states violates the 14th amendment, then federal revenue sharing to equalize school financing becomes mandatory.