

## CENTRALIZED VERSUS DECENTRALIZED FINANCE

Harold M. Groves, professor of economics, University of Wisconsin

It is an accepted rule that the Government should not perform functions that can as well be performed privately and that the Federal Government should not perform functions that can as well be performed by State and local governments. Unfortunately this doesn't help very much in making decisions as to whether functions should be assumed by the Federal Government or left to the States.

### PRESUMPTION FAVORING DECENTRALIZED FINANCE

The presumption in favor of State and local government is based on the faith that decentralization is an important constituent of democracy. This faith is particularly plausible insofar as it applies the rule that matters which are solely or perhaps mainly of concern to a particular area should be left to the people of that area for decision. This interest in local autonomy carries the title "Home Rule" and it is guarded as jealously (and as frequently violated) as the similar right of the private individual to mind his own business when it does not conflict with that of somebody else.

Beyond this interest in home rule there are values in local government that are lost when responsibilities are assumed by central governments. One of these is participation—government by the people. The private citizen undoubtedly finds opportunities to participate in government at the local level which cannot be duplicated at the national level. At the city hall or State capitol any public-spirited citizen can reach his alderman or legislator in person and he can appear to express his views at a public hearing. An ordinary "dirt farmer" can do all of this and get home in time to milk the cows. It may be prohibitively expensive for him to go to Washington and, anyway, he would need an elaborate organization to make much impression there. Rated by degree of participation, most democratic government is that by popular assembly or referendum where representatives can be dispensed with entirely. Next best is representative government in a small enough circle so that the ordinary citizen without undue sacrifice can make himself heard and felt.

Local government also offers to many an opportunity to participate in government in positions of responsibility. There are thousands of people whose career as a representative of the people is and will be confined to membership on the school boards of our some 65,000 school districts. This is not only of some value in itself—it is a training school and a testing ground from which the upper echelons of government recruit talent.

Local governments also serve as experiment stations in which new ideas may be tried out without the risk and expense (to say nothing

of the inertia) that would be involved if the experiments were national in scale.

These positive values of local government are reinforced by the negative aspects of far-flung centralized bureaucracy. Distrust of such is deeply rooted among Americans, especially those who lean toward an antimonopoly philosophy. Central government is not only big; it is also single; it possesses unique coercive powers; and it offers no alternatives to its customers. Like all large monopolistic organizations it suffers the inefficiencies that rise from inadequate knowledge at the center of what is really needed at the periphery.

Of course, it can be argued plausibly that some central sharing in the financial support of local functions is quite different from Federal assumption of sole responsibility and control in these areas. It is argued that in communities with limited resources, grants-in-aid may increase local independence by freeing some of their limited funds for services of their own choosing. But this new freedom is like that of a son who earns part of his support and gets the remainder in a regular (but not guaranteed) allowance from his benevolent parents. He is not really fully free and responsible until he subsists on his own income supplied by himself.

#### THE CASE FOR CENTRALIZED FINANCE

All of the above is widely appreciated in this country. But there is another side of the picture that offers persuasive support for a degree of centralized responsibility at least greater than that which prevailed in the 1920's.

##### *Slow progress and undemocratic procedures in State government*

The States and municipalities (particularly the former) would be in a stronger position as candidates for more responsibilities if they had (or would) put their own house in order. Following the Commission on Intergovernmental Relations one can list the areas that need attention as follows:

1. There are antiquated representation systems that underrepresent large and recently developed centers of population in one or both legislative bodies. What becomes of the democratic principle when a majority in the legislature can be elected by a quarter of the eligible voters and when A's vote counts for 10 times as much as B's? Some of this might be defended on the dubious ground of area representation; most defense is the obvious rationalization of a special interest. Some progress in reapportionment is being made continuously but it is not enough to offset population changes now going on; thus on balance the problem is a growing one. Some effort has been exerted to devise machinery that can cope with vested interests in this area but it has been successful in only a few States.

2. There are antiquated constitutions providing for weak executives, too many elected officers, too infrequent legislative sessions and budgets, too limited financial powers.

3. There are still many cases of civil service infested with patronage and with the inferior talent that must be expected at highly inadequate salary scales.

4. There is the record of neglect in dealing with the metropolitan problem regarded by many critics as the No. 1 domestic issue. This

is the problem which has resulted from the recent vast movement of population into some 168 metropolitan areas and out of their centers to their peripheries. If these areas had governments coterminous with their functions they would still be hard pressed with such matters as strangulating traffic, decadent sections, crowded schools, delinquent gangs, and of course excessive tax rates. Usually added to all this is an antiquated political geography with many units of government, some of them poaching on their neighbors. One district may have a factory and another the workers. These problems will not yield except to great courage and imagination at the State level. Not too much of this kind of leadership has developed.

#### *Regressive taxation*

The States and municipalities have on the whole a regressive tax system based at the local level on the general property tax and at the State level on the retail sales tax. The Musgrave studies<sup>1</sup> have indicated that in State and local taxes the poorest bracket of taxpayers (\$0 to \$2,000 net income) pay almost half again as much per thousand dollars of net income as the well-to-do (over \$10,000 net income). Moreover, there is ground for the view that the trend is toward more regressivity. Eleven States have enacted sales taxes since World War II and no States have enacted new net income taxes. This means that a vote for decentralizing the financial responsibility for a function is a vote for regressive as against progressive taxation. This is not a matter of equity alone; it also involves economics. It is the progressiveness of the tax system that gives it much of its built-in flexibility—its propensity to produce automatic surpluses and deficits to meet the needs of compensatory budgeting.

Those who favor decentralization should logically be in the front rank of the crusaders for better and more aggressive State and local government. Actually this is often not the case and it leads to the conclusion that these people are probably more interested in less government, less total taxes, and less taxes for themselves than in decentralization as such.

#### *Interstate competition*

The States and municipalities are in a relatively weak financial position because they are amenable to interterritorial competition to a far greater degree than the Federal Government.

The proposition that Federal aid involves only the collection of revenue that might have been raised locally, the sending of this revenue to a distant capital, from whence it is returned with some part missing, is at most a half-truth. The full truth would add that if the central government (for better or for worse) did not support this function and raise the tax for it, the function probably would not be supported at all and the tax for it would not be raised. The competitive factor, among others, also provides a rationale for distributing aid to strong districts as well as weak ones.

The degree to which taxation influences industrial location and the degree to which competition influences State and local decisions concerning taxation are matters long in dispute. It is evident that State

<sup>1</sup> Richard A. Musgrave, *Incidence of the Tax Structure and Its Effects on Consumption, Federal Tax Policy for Economic Growth and Stability*, Joint Committee on the Economic Report, 84th Cong., 1st sess., 1955, pp. 96-113.

and local governments are not completely captive and that the deductibility of State and local taxes on Federal income-tax returns gives them some protection. State and local government under the pressure of earlier public works postponement and increased population have been expanding their outlays for public services with some aggressiveness. It is true also that no empirical study has ever established the alleged fact that areas with high taxes or relatively progressive tax systems have suffered in industrial development. But anyone who observes legislative bodies cannot doubt that the pressure is real and important. It is nonetheless real because a lot of it is mainly fear psychology.

The degree of interterritorial competition is probably increasing. A perusal of newspapers and magazines indicates that the "booster spirit" is everywhere going strong. It takes the form of advertising, developmental corporations, subsidies, tax exemption, and a "favorable tax climate." Concerning the latter one former director of a State division of industrial development observed:<sup>2</sup>

In an era of industrial mobility, no State can stand alone in its adherence to a tax structure strongly oriented to the "ability to pay" theory. Continued adherence to this theory, in the face of defections by contiguous or "competitive States" will have the certain long-range effect of decreasing the rate of personal-income growth and denying improved employment opportunity to the very persons supposedly benefited by the application of this theory.

### *Interdependence*

The trend of the times is toward more interdependence. This thesis can be supported by the impressive evidence concerning migration, travel, and interterritorial exchange of all sorts. This interdependence means that the people of Podunk, N. Y., have some equity in the maintenance of public standards in Podunk, N. Mex., and vice versa. It is characteristic of the satisfaction of human wants through government that the benefits derived from government outlay are largely indirect and frequently extraterritorial.

The growth of interdependence is particularly relevant with regard to education. Educational standards may seem at first to be of concern mainly to pupils and parents or at most the citizens of the community in which the youth are reared. But what becomes of this conclusion when we confront the statistics of migration and observe how many now being educated in one community turn up eventually as workers and citizens of another?

Interdependence means that the interest in many matters formerly of strictly local concern is now a divided one. The degree of interest for parties involved is difficult to discern and to implement. Our Federal aid system is one means by which a partnership of interest is combined with a partnership of financial responsibility and control. The control issue is the most sensitive one; the Kestnbaum Commission surveyed this area with great care and although it recommended some changes in detail, it is fair to say that on the whole it found the controls conservative and salutary. They have encouraged such State

<sup>2</sup> Robert D. Siff, *Some Pertinent Points on Industrial Development Policies, Tax Policy*, Tax Institute, Princeton, vol. XXIV, Nos. 2-3, 1957, p. 11.

improvements as merit-system civil service and State highway departments.

*The general level of public expenditures*

It is apparent that one's reaction to the question of Federal versus State financial responsibilities is conditioned considerably by his reaction to public expenditures as such. If he thinks they are too high he will probably favor decentralization. The States and municipalities for reasons previously cited will not spend as freely as does the Federal Government with its far superior taxing power. The proper level of overall public expenditures is the subject for other panels. Here it may be said that proponents of liberal government spending have these points on their side:

As the economy advances and per capita income increases, free income (above biological necessities) increases still faster. This free income is subject to a degree of discretion not true of the hard core of necessities. It is everywhere devoted in large measure to services where the Government competes with private disposition most effectively. Some of the ugliest aspects of the American way of life, such as slums, crowded schools, youth delinquency, and mental illness are in the area where government programs are most effective. The wastes of government are regrettable but they probably are minor compared with those of private consumption which in the United States are legendary. The typical American consumer thinks nothing of driving a station wagon across town to mail a letter. Governments are sometimes extravagant but they also frequently are niggardly. The case I know best is the Internal Revenue Service which in the opinion of many critics has always been substantially undermanned. Under present conditions the belief that the acceleration of private expenditures as against government expenditures necessarily results in the healthiest society is not tenable.

#### CENTRALIZATION AND ECONOMIC CONTROL

One would be insensitive to the wave of the present if he did not attempt to relate our problem to that of controlling inflation. For the maintenance of at least the present Federal role in the overall expenditure picture it can be said, looking at the long run, that Federal expenditures and taxes are more amenable to control than those of the States; that the government's large role in the economy is what makes compensatory controls effective and that this role would diminish if the Federal Government relinquished a large area to the States; that it is the predominantly progressive overall tax system that affords built-in flexibility and that this is maintained only by the Federal Government's role. On the other hand controllability is no good if it isn't used; this seems to indicate a reduction in Federal expenditures now that inflation is our gravest problem; if the States do not take up the slack, so much the better. Those who cherish Federal expenditures for their nonfiscal or institutional objectives have the obligation to offer some remedy for inflation other than reduced public expenditures.

Of course, what would really now aid the States would be an acceleration of economic growth, an end to inflation, a loosening of tight money (which interferes with their borrowing), and a con-

tinuance of Federal spending at least insofar as it supports the States. This program sounds a little like the politician's platform of a soldiers' bonus, reduced taxes, and a balanced budget. But we have not exhausted the field when we have accepted a high level of public expenditures and rejected tighter money as remedies for inflation. Simplest but not the most popular remedy is to plug loopholes in existing taxes and thus add to the Federal budget surplus. Obviously cutting taxes and letting expenditures ride is a perverse answer. Perhaps we should look for something new as an inflation control; for example, decelerated depreciation, a tax on bank loans, and a sales tax on industrial equipment have been suggested. A graduated overall expenditure tax to supplement the income tax would be a promising instrument of control if it could be administered.

On the other hand, if as alleged and as seems probable, our present inflation problem is due in large part to cost-push causes; that is, to monopolistic pressure (business and labor) upon the price level, then we surely have to look for something new in inflation controls. The nearest thing to a fertile suggestion that has so far come to our attention is that of Sumner Slichter to disallow wage increases (for a time) as corporate income-tax deductions. Alternatively we might levy a special payroll excise tax in much the same way and to the same effect. These proposals involve the administrative problem of separating wage increases from payroll additions due to expansion; and they throw all the onus of monopolistic pricing on labor. It would be more logical to levy a special sales tax on the receipts from price increases; but in only a few cases are commodities sufficiently standardized to separate genuine price increases from changes due to innovation in product. To all of these possibilities the objection will be made that they constitute government tampering with the free market. But here the ready answer is that it is the absence of a free market that creates our problem to begin with.

At any rate it seems inadvisable to reorder our intergovernmental fiscal relations as a remedy for inflation. That some Federal expenditures can and should be cut is conceded, but most of them (from our point of view) are inelastic in the downward direction. And in some areas expenditures should be increased.

This is not to say that nothing should be done about inflation. The author will not attempt here to arbitrate among the several suggestions listed above, but he does wish to leave the thought that the time is ripe for the exercise of some further ingenuity with regard to the inflation problem.

#### QUANTITATIVE PICTURE OF FEDERAL-STATE FINANCE

We may turn now before drawing a conclusion to the quantitative picture and ask what it shows regarding the alleged encroachment of the Federal Government on the States. Over the long view, the relative position of State and local governments in total expenditures has undoubtedly dropped sharply. In 1927 State and local expenditures were nearly three-quarters of the total (73.1 percent); in 1940 they were still more than half (52.8 percent); and in 1956 a little more than one-third (33.6 percent). The 1956 proportion is the same as that of 1948, indicating no postwar trend. Much of the recent alleged

aggrandizement of the Federal Government has been for military items; if they are abstracted from the picture, Federal, State, and local outlays are not far from equal. This was also true during the late 1930's when the military proportion of the Federal budget was much less. As to Federal aid, since 1940 it has increased more rapidly than State and local expenditure but less rapidly than total expenditure. Over the longer pull, however (comparing the present Federal position with that of the late twenties), the Federal role by any standard has increased quite substantially. The expansion occurred during the thirties and included, of course, the important area of social security.

Comparing the United States with other countries as to centralization one finds such data as the following (the figures indicate the ratio of local taxes to total taxes 1947-53):<sup>3</sup>

United Kingdom.....	8	Italy.....	18
France.....	13	Switzerland.....	51
Germany.....	14	Canada.....	26
Sweden.....	25		

In conclusion and to indicate a personal position on our problem, the author finds himself in general agreement (as to the matters discussed in this paper) with the Kestnbaum Commission's report which may be summarized as follows: The Federal system on the whole was found to be in healthy condition; the values of local autonomy are real and important and always need stressing; these values may be overbalanced by the great advantages of national or joint action in particular areas changing with time; it behooves the States deploring Federal encroachment to put their own houses in order. The States and municipalities are still finding plenty of scope for such vision, energy and ingenuity as they are able to summon. The Federal system in this country has preserved a degree of local autonomy unsurpassed at least by that of any of the world's great powers.

The pragmatic and sensible solution of Federal problems is not likely to lie in loyalty to any slogan but in the balanced weighing of values in the case of each new issue as it arises.

<sup>3</sup> Economic Commission for Europe (Research and Planning Division), *Changes in the Structure of Taxation in Europe*, Economic Bulletin for Europe, vol. II, No. 3, Geneva, 1951, p. 59; Canadian Tax Foundation, *The National Finances, 1954-55*, Toronto, p. 10.