FEDERALISM AND FISCAL EQUITY

By James M. Buchanan*

Fiscal relations between central and subordinate units of government have become an important problem area in the United States during the last two decades.[1] Increasing attention has been, and is being, given to the more practical policy proposals aimed at accomplishing specific short-run objectives. While this may have been necessary, perhaps too little attention has been placed upon the study and the formulation of the long-run objectives of an intergovernmental fiscal structure.[2] This paper seeks to formulate a specific long-run goal for policy and will discuss the advantages which might be expected to arise from its general acceptance.

I

A distinct group of problems immanently arise when a single political unit possessing financial authority in its own right contains within its geographical limits smaller political units also possessing financial authority.[3] These problems become especially important in a federal polity since the financial authority of the subordinate units is constitutionally independent of that of the central government. In a federalism, two constitutionally independent fiscal systems operate upon the fiscal resources of individual citizens.[4]

The fiscal system of each unit of government is limited in its operation by the geographical boundaries of that unit; it can withdraw re-

* The author is associate professor of economics at the University of Tennessee.

[1] The most general survey of the whole field published to date is: U. S. Congress, Senate, *Federal, State and Local Government Fiscal Relations,* Sen. Doc. 69, 78th Cong., 1st Sess. (Washington, Government Printing Office, 1943). Other competent works include: J. A. Maxwell, *The Fiscal Impact of Federalism in the United States* (Cambridge, Harvard University Press, 1946); Jane P. Clark, *The Rise of a New Federalism* (New York, Columbia University Press, 1938); G. C. S. Benson, *The New Centralization* (New York, Farrar and Rinehart, 1941).

[2] One important work in the field is concerned with this aspect. B. P. Adarkar, *The Principles and Problems of Federal Finance* (London, P. S. King and Sons, 1933).

[3] Financial authority may be defined as the power of a governmental unit to collect revenues from contained fiscal resources and to expend such revenues in the performance of governmental functions. *Cf.* Adarkar, *op. cit.,* p. 31.

[4] The individual must deal with three or more fiscal systems, federal, state, and one or more local units. Local financial authority is, however, derivative from that of the state, and for present purposes, the combined state-local fiscal system will be considered as one unit.

sources for the financing of public services only from those available within this area. If the subordinate units are required independently to finance certain traditionally assigned functions, fiscal inequalities among these units will be present unless the fiscal capacities are equivalent. There will be differences in the number and/or the standard of the public services performed for and/or the burden of taxes levied upon the owners of economic resources within the separate units. The nature and the extent of these differences, and the difficulties involved in their elimination, constitute the elements of the over-all fiscal problem of the federal polity.

The situation has grown progressively more acute in the United States. This can be attributed largely to the three following parallel historical trends: First, the continual industrialization, specialization, and integration of the economy on a national scale has tended to concentrate high income receivers in specific geographical areas. Second, there has been an extension of the range of governmental activity at all levels in the political hierarchy. This has required the diversion of greater and greater shares of the total of economic resources through the fiscal mechanism. Third, this extension of governmental activity at the lower levels of government (and in peacetime at the top level) has taken place largely through the increase in the provision of the social services. This when coupled with the type of tax structure prevailing has increased the amount of real income redistribution accomplished by the operation of the fiscal system.

In 1789, a significant share of economic activity was limited to local markets; there was relatively little areal specialization of production. Governmental services were performed predominantly by the local units which were drawn up roughly to correspond in area to the extent of the local markets. Rapid developments in transportation and communication led to an ever-increasing specialization of resources. The economy grew more productive, but the inequalities in personal incomes and wealth increased. This emerging inequality was both interpersonal and inter-regional; expanding individual differences were accompanied by closer concentration of the higher income recipients in the more favored areas. This created disparities among the states in their capacities to support public services.

These fiscal divergencies were not conspicuous, however, until the extension of governmental activity caused the traditional sources of revenue to become inadequate. As greater amounts of revenue were required at all levels, conflicts over revenue sources among state units, and between states and the central government, arose.

The form which the extension of governmental activity took was an important determining factor in making the problem more difficult.

Even with the increasing costs of government, inter-regional disparities in fiscal capacity would not have been accentuated had not the extension taken place largely through the expanded provision of the social services. Had the rôle of government remained "protective," and thus the fiscal system conformed more closely to the benefit or *quid pro quo* principle, richer units would have needed greater governmental expenditures. Only when the "social" state appeared did the divergency between need and capacity become clear. As more government services were provided equally to all citizens, or upon some basis of personal need, the discrepancies between the capacities and needs of the subordinate units arose.

The emerging fiscal problem has been only one of many created by the progressive national integration of the economic system within a decentralized political structure. This development has caused many students to view the political structure as outmoded, and the federal spirit as a thing of the past.[5] The federal polity has outlived its usefulness, and the conditions which made it necessary as a stage in the process of political development no longer prevail.[6] It is true that complete political centralization would resolve the peculiar fiscal problem of federalism. If there were only one fiscal system, as there would be in a unitary form of government, regional differences in standards of public services and/or burdens of taxation would not exist.[7] But political centralization as a proposal for solution is precluded if we accept the desirability of maintaining the federal form. The approach taken in this paper accepts the federal political structure, with the existence of the states as constitutionally independent units sovereign within specified areas. Thus, the problem is reduced to that of formulating a solution within this given framework.

The same problem of fiscal inequality is, of course, present among local units of government within the same state unit. However, the scope for adjustment by non-fiscal means, through political or administrative devices (local government consolidation, state assumption of local functions, etc.), seems broader in state-local relations. The policy proposals stemming from the analysis which follows presume a fixed political structure. But it should be emphasized that both the analysis and the policy implications can be extended to inter-local unit fiscal

[5] See Roy F. Nichols, "Federalism vs. Democracy," *Federalism as a Democratic Process* (New Brunswick, Rutgers University Press, 1942), p. 50.

[6] Gordon Greenwood, *The Future of Australian Federalism* (Melbourne, Melbourne University Press, 1946), p. viii.

[7] The proposal for integration and unification of the fiscal systems at different levels has been excellently presented by Professor S. E. Leland. See, for example, his "The Relations of Federal, State, and Local Finance," *Proceedings, National Tax Association,* Vol. XXIII (1930), pp. 94-106.

adjustment as well as to interstate fiscal adjustment. Subsequent discussion will, however, be limited to the latter.

II

The ideal type adjustment can be presented in reference to the relative fiscal systems of different state units which possess the same fiscal capacity. If all states were approximately identical in per capita incomes and wealth, the burden of taxation upon resources would not necessarily be equal in all. Neither would the general level nor the distribution of public services be equivalent. Some states might choose to tax more heavily and thus provide a higher level of public services than other units equal in fiscal potential. The criterion of comparison must be some balance between the two sides. Both the level of tax burden and the range of publicly provided services must be included. Units of equal fiscal capacity should be able to provide equivalent services at equivalent tax burdens.

An intergovernmental transfer system can be worked out which would allow state units originally unequal in fiscal capacity to provide equal services at equal rates of taxation. The explicit objective of such a system would be the placing of all state units in a position which would allow them to provide a national average level of public services at average tax rates.[8] Immediately there arises the difficult task of determining average rates of taxation and average standards of public service. A more important objection to the statement of the policy goal in this form is that it appears in terms of adjustment among organic state units. Equality in terms of states is difficult to comprehend,[9] and it carries with it little ethical force for its policy implementation. And, is there any ethical precept which implies that states should be placed in positions of equal fiscal ability through a system of intergovernmental transfers?

If the interstate differences in fiscal capacity can be traced through to their ultimate impact upon individuals, and a policy objective formulated in inter-personal terms, it would seem that greater support could be marshalled for interstate fiscal equalization. Any discussion of the operations of a fiscal system or systems upon different individuals or families must be centered around some concept of fiscal justice. And although fiscal justice in its all-inclusive sense is illusory and almost

[8] This is the policy objective of the National Adjustment Grants proposed by the Royal Commission on Dominion-Provincial Relations after a study of the problem in Canada. See *Report of the Royal Commission on Dominion-Provincial Relations,* Book II, *Recommendations* (1940).

[9] See R. McQueen, "Economic Aspects of Federalism: A Prairie View," *Canadian Jour. Econ. and Pol. Sci.,* Vol. 1 (1935), p. 353.

purely relative to the particular social environment considered, there has been contained in all formulations the central tenet of equity in the sense of "equal treatment for equals" or equal treatment for persons dissimilar in no relevant respect.[10] This basic principle has been so widely recognized that it has not been expressly stated at all times, but rather implicitly assumed. Whether or not this principle is consistent with maximizing social utility,[11] it is essential as a guide to the operations of a liberal democratic state, stemming from the same base as the principle of the equality of individuals before the law.[12]

The statement of "equal treatment for equals" as a central principle immediately raises the question of defining precisely the conditions of equality which are relevant in fiscal policy, and more especially intergovernmental fiscal policy. Traditionally, rather objective measures or standards have been accepted, and the divergency between the equality represented in these and subjective or psychic quality has been neglected. Money income and estimated property values in money have therefore been used as the bases for judging individual standing for tax purposes. Some allowance has been made for family size, for income source, and for other differences generating real income effects, but differences in geographical location have not been held to warrant differences in tax treatment.[13] There seems no special reason why intergovernmental fiscal adjustment policy should be set apart in this regard from national government tax policy. Thus, "equals" in the following analysis are individuals equal in those objective economic circumstances traditionally employed in the calculation of national government tax burdens.[14] Through the use of this definition of equals and the adoption of the equity principle, a formal solution to the fiscal problem of federalism can be worked out. This allows the problem to be isolated and sepa-

[10] "Different persons should be treated similarly unless they are dissimilar in some relevant respect." (A. C. Pigou, *A Study in Public Finance* [London, Macmillan, 1929], p. 9.)

[11] If all aspects of equality, including utility or pleasure creation, are included in the definition of "equals," then the principle will be directed toward maximum social utility but will be useless due to the impossibility of application. This would be true because any application would require some inter-personal comparison of utility. Any realistic definition of "equals" must omit subjective attributes of equality; therefore, the application of the principle does not necessarily maximize social utility.

[12] *Cf.* J. S. Mill, *Principles of Political Economy* (Boston, Charles C. Little and James Brown, 1848), Vol. II, p. 352.

[13] Differences in geographical location perhaps cause significant differences in real incomes among particular individuals, but these would seem to be offsetting when large numbers of individuals are considered. If the real incomes of all, or large numbers of, individuals, were increased or decreased by location in particular geographical areas, then these differences would become relevant for fiscal policy.

[14] This analysis does not require any particular set of attributes of equality. All that is required is that geographical location not be included.

rated from the much more difficult one of the distribution of fiscal burdens and benefits among unequals, in which an explicit formulation of "justice" is impossible.

III

What is equal fiscal treatment for equals? The orthodox answer has been almost wholly in reference to the tax side alone, the implication being that if tax burdens of similarly situated individuals were identical, the equity criterion would be satisfied. The necessity of including the benefit side of the fiscal account has been overlooked completely in many cases, and understressed in all.[15] The object of comparison should be the aggregate fiscal pressure upon the individual or family, not tax treatment alone. The balance between the contributions made and the value of public services returned to the individual should be the relevant figure. This "fiscal residuum" can be negative or positive. The fiscal structure is equitable in this primary sense only if the fiscal residua of similarly situated individuals are equivalent.

It is next necessary to define the appropriate political structure to be considered in its relative impact on individuals. In a federal polity, the individual has a plurality of political units with which to deal fiscally. Two or more independent fiscal systems act upon his economic resources, subtract from those resources through compulsory taxation, and provide in return certain public services. In this situation, what becomes of the criterion of equity postulated? Each political unit may treat equals equally.[16] If this were done, individuals similarly situated would be subjected to equal fiscal treatment only if they were citizens of the same subordinate unit of government. There would be no guarantee that equals living in different subordinate units would be equally treated at all. Therefore, the principle of equity must be extended to something other than individual governmental units to be of use in solving the fiscal problem of federalism.

The limitation of the application of the equity principle to single fiscal systems within a federal polity can be questioned. It can be plausibly established that the appropriate unit should be the combined "fisc," including all the units in the political hierarchy. The argument can take either or both of two forms.

[15] For a further elaboration on this and related points, see the writer's, "The Pure Theory of Government Finance: A Suggested Approach," *Jour. Pol. Econ.*, Vol. LVII (Dec., 1949), pp. 496-505.

[16] This requirement has been expressly stated by one student of the problem. "In a democratic society considerations of equity demand that governmental programs *at each level* treat all citizens in similar circumstances uniformly" (italics supplied). (Byron L. Johnson, *The Principle of Equalization Applied to the Allocation of Grants in Aid,* Bureau of Research and Statistics Memo. No. 66 [Washington, Social Security Administration, 1947], p. 88.)

(a) In the United States, the economy, for all practical purposes, is national in scope. In large part, resources are allocated in response to incentives provided in a nationwide market for both final products and for productive services. Goods are sold and equities are traded nationally. The fiscal system represents the political unit in its direct impact upon the economy. Therefore, since the economy is national, the matching political structure must be considered as one unit in its operations upon that economy.[17] If it be accepted that one of the guiding principles in the operation of a fiscal system should be that of "least price distortion,"[18] or least interference with efficient resource allocation consistent with the attainment of other specific objectives, the necessity of this approach becomes clear. The principle of equal treatment of equals is consistent with that of least price distortion only if the "treatment" refers to that imposed by a political unit coincident in area with the economic entity. This is, in the United States, the whole political structure, central and local. For, in a federal structure with economically heterogeneous subordinate units, some interference with the proper resource allocation necessarily arises, unless some interarea fiscal transfers are made.

Fiscal pressures are economic in nature, whether expressed as net burdens or net benefits. If states are not identical in fiscal capacity, the people in the low capacity (low income) states must be subjected to greater fiscal pressure (higher taxation and/or lower value of public services) than people in high capacity states. If "equals" are thus pressed more in one area than in another, there will be provided an incentive for migration of both human and non-human resources into the areas of least fiscal pressures. Resources respond to market-determined economic reward, plus fiscal balance. If the fiscal balance for equals is not made equivalent for all areas of the economy, a considerable distortion of resources from the allocation arising as a result of economic criteria alone might result. The whole fiscal structure should be as neutral as is possible in a geographic sense.[19] An individual should have the assurance that wherever he should desire to reside in the nation, the over-all fiscal treatment which he receives will be approximately the same.

[17] Accepting this does not imply that the political structure should be one unit as has been proposed. There may be, and in my opinion are, definite values to be gained in maintaining a decentralized political structure. The purpose of this paper is that of showing how this decentralization might be retained while still solving the fiscal problem.

[18] F. C. Benham, "What is the Best Tax System?" *Economica,* Vol. IX (1942), p. 116.

[19] This should not be taken to imply that complete neutrality in this sense could ever be reached. Even with a transfer system worked out along the proposed lines, differences among states would always be present to provide some distortionary effects. In the non-geographic sense, the fiscal structure will, and should, have some distortionary effects, if the whole system is redistributive.

It seems somewhat anomalous that states are forced through constitutional provision to remain parts of a national economy in the market sense and yet are forced to act as if they were completely independent economic units in their fiscal operations. This was recognized by William H. Jones in 1887, when he proposed a system of centrally collected taxes shared equally per head among states.[20] Requiring state areas to remain integrated in the national economy is inconsistent with the forcing of the governmental units of these areas to act as if the economies were fiscally separate and independent. This inconsistency can only be removed by centralization of fiscal authority or by the provision of some intergovernmental fiscal adjustment.

(b) The appropriateness of using the whole political structure as the unit in fiscal equity considerations can be justified in another way. Prior to the impact of the fiscal system, the income distribution arises largely as a result of the payment for resources in accordance with productivity criteria and competitive conditions established on a national basis. The fiscal system is the major means through which this income distribution is redressed toward one which is more ethically acceptable. It follows, then, that the fiscal system, in carrying out this function, should operate in a general manner over the whole area of the economy determining the original distribution. The generality with which the "fisc" can be operated has been held to be one of its important advantages over redistribution methods which entail particularistic or discriminatory interference with the economic mechanism. But unless the fiscal system is considered that of the whole hierarchy this advantage of generality is lost, and the system necessarily operates in a geographically discriminatory fashion.

The application of the equity principle on the basis of considering the whole political hierarchy as the appropriate unit will yield substantially different results from its application on the basis of considering separate governmental units in isolation. If there are subordinate units of varying economic characteristics within the central government area, the equity principle applied to the whole hierarchy will require that the central government take some action to transfer funds from one area to another. Thus, the central government, considered alone, must violate the orthodox equity precept since it must favor the equals residing in the low capacity units. The central financial authority must enter

[20] ". . . so long as we persist in applying the principle of autonomous State taxation under Federal forms, and Federal principles of trade and intercourse for purposes of Federal autonomy, the malady will stick to the patient.

This mingling of autonomous State taxes and Federal principles of free interstate trade and citizenship for purposes of Federal autonomy, is contrary to both the letter and spirit of the Federal Constitution." (William H. Jones, *Federal Taxes and State Expenses* [New York, G. P. Putnam's Sons, 1887], pp. 86-87.)

the process and treat equals unequally in order to offset the divergencies in the income and wealth levels of the subordinate units.[21]

The necessity of assigning this rôle to the central unit in no way implies that the over-all fiscal system be unified in the sense that all financial decisions be made by one authority. Subordinate units should be able to retain complete authority. Neither the tax burdens nor the standards of public service need be equal for "equals" in any of the states. Satisfaction of the equity criterion requires only that the residua be substantially the same.

The policy objective for intergovernmental transfers then becomes one, reduced to individual terms, of providing or ensuring "equal fiscal treatment for equals." If this objective is attained, the individual's place of residence will no longer have a significant effect upon his fiscal position. Persons earning the same income and possessing the same amount of property will no longer be subjected to a much greater fiscal pressure in Mississippi than in New York, solely because of residence in Mississippi.

That a much greater and more effective force can be mustered in support of a transfer system worked out on this basis does not seem open to question. Reduced in this way to a problem of fiscal equity among individuals, the need for inter-area transfers becomes meaningful. Although the results of the working out of such a proposed system would perhaps differ little, if at all, from those forthcoming from a system based upon equalizing the fiscal capacities of the state units, the former carries with it considerable ethical force for its implementation while the latter does not. The ideal of "equal treatment for equals" is superior to that of equalization among organic state units.

IV

The following arithmetical illustration is presented to show how the use of the equity principle can lead to a determinate system of transfers in a simplified model. Assume that in a hypothetical federal government, X, there are two states, A and B. The total population of X is six citizens, with three residing in each state. Their names are A-1, A-2, A-3, B-1, B-2, B-3. The economic characteristics of X are such that in A, two skilled workers and one unskilled worker can be employed, while in B, one skilled worker and two unskilled workers can be employed. Differences in the natural abilities of the six men are such that only three are equipped to do the skilled work, A-1, A-2, and B-1. The other three must do unskilled work. There are no non-pecuniary advantages to employment in either state. The six men are sub-

[21] "The position that the federal government would occupy in the scheme is that of filling in the gaps of unevenness as between one state and another." (Adarkar, *op. cit.*, p. 195.)

stantially similar in all other respects. The relative money incomes for the two groups are $10,000 per year for the skilled workers, and $1,000 per year for the unskilled. Therefore, A has two citizens receiving $10,000 and one receiving $1,000, while B has one $10,000 man and two $1,000 men.

Let it be assumed further that the central government imposes a progressive income tax amounting to 10 per cent of the higher incomes and 5 per cent of the lower incomes. All of its revenue is derived from this source. States A and B impose proportional taxes at the rate of 10 per cent on incomes. All their revenue is derived from this source. The tax liability of each of the citizens then is as follows:

Name	*Collected by X*	*Collected by A or B*	*Total*
A-1	$1,000	$1,000	$2,000
A-2	1,000	1,000	2,000
A-3	50	100	150
B-1	1,000	1,000	2,000
B-2	50	100	150
B-3	50	100	150

It can be easily seen that if tax liability alone is considered, the over-all fiscal structure is equitable in the primary sense. Equals are treated equally. But if both sides of the fiscal account are included, glaring inequities in the treatment of equals appear.

Now, let it be assumed that both the central government, X, and states A and B, expend funds in such a manner that all citizens within their respective jurisdictions benefit equally from publicly provided services. The central government collects a total of $3,150 and when expended each citizen gets a value benefit of $525 from services provided by that unit. State A collects $2,100 from its three citizens, and each gets in return a value benefit of $700 from public services provided by A. State B collects $1,200, and each citizen thus receives only $400 in value benefit from public services provided by B. The final fiscal position of each of the citizens is represented in the following:

Name	*Total Taxes*	*Total Benefits*	*Fiscal Residuum*
A-1	$2,000	$1,225	$ 775
A-2	2,000	1,225	775
A-3	150	1,225	— 1,075
B-1	2,000	925	1,075
B-2	150	925	— 775
B-3	150	925	— 775

B-1 is taxed at equal rates with his equals, A-1 and A-2, by both the central government and the state, and receives the same benefits from the central unit, but he receives $300 less in benefits from his state. His fiscal residuum is $1,075 (taxes over benefits) as compared with $775 for his equals. Likewise, the fiscal residuum of B-2 and B-3 is a negative $775 (benefits over taxes) while that of their equal, A-3, is a negative $1,075.

If a transfer of $200 were made among the set of high income equals in this model, from State A to State B, thus reducing the residuum or net tax of B-1 by $200 and increasing that of A-1 and A-2 by $100 each, then each of this group would end up with a residuum of $875. A further transfer of $200 from A-3 to B-2 and B-3 would equalize the negative residua of the low income equals at $875. Thus, a total transfer of $400 from A to B would enable the equals to be placed in identical fiscal positions.

This model presents the use of the equity principle in its most favorable abstraction. Certain major qualifications must be made if the principle is to be universally applicable even in such structurally simple models. In the above model, both state units imposed taxes at the same flat proportional rate and distributed benefits equally per head, while the central government imposed progressive tax rates and distributed benefits equally among its citizens. It is necessary to examine these conditions and trace through the effects of possible changes upon the results. First of all, it can be shown that the central government acting alone can vary the progressiveness or redistributiveness of its fiscal system (either on the tax or expenditure side, or both) without in any way affecting the resulting transfer total.[22] This is, of course, due to the fact that the central government system, in principle at least, treats equals equally, and thus no action carried out by this system alone would affect the existing inequalities among equals.

Second, it can be shown that the transfer total is not changed by a simple increase (decrease) in the desires of the citizens of one state for public services. The result will be changed only if, in the process of providing the increased (decreased) services, the redistributiveness of the state fiscal system is affected. For example, either of the states in the above model, desiring to provide additional services, could levy

[22] This can be illustrated by changing the above model to one in which the central government collects all its tax revenues from the three high income receivers. The resulting individual fiscal positions are then as follows:

Name	*Total Tax*	*Total Benefit*	*Residuum*
A-1	$2,050	$1,225	$ 825
A-2	2,050	1,225	825
A-3	100	1,225	— 1,125
B-1	2,050	925	1,125
B-2	100	925	— 825
B-3	100	925	— 825

It can be seen that a transfer of $400 will again place equals in identical fiscal positions. Absolute differences among equals have not been changed by the increase in the progression of the central government tax structure. It will be noted, however, that the fiscal positions of the citizens of B have been improved relative to those of A's citizens.

equal per head poll taxes of any amount without changing the required transfer total at all.

This is not the case, however, when the amount of redistribution carried out in the operation of either or both of the state fiscal systems is changed. Such a change can be carried out by shifts in the allocation of tax burdens or benefits among the different income classes, or through altering the total amounts of economic resources entering the fiscal systems. The limiting case is that in which neither state system is at all redistributive, both operating on purely benefit principles.[23] In this case, each individual receives in value benefits the equivalence of contributions made, *i.e.*, has a zero residuum. Thus, whatever the income differences among the units, equals are equally treated, and no required transfer is indicated. Thus, it can be stated that as the fiscal system of either of the state units is shifted more toward operation on a benefit basis, *i.e.*, is made less redistributive, the required transfer between the high income state and the low income state is reduced. Conversely, as either system is made more redistributive, a greater transfer is necessary to satisfy the equity criterion.[24] This dependence of the resulting transfer total upon the redistributiveness of the state fiscal systems creates difficult problems in the use of the principle as a direct guide for policy. Since a state unit can by its own action in shifting its internal fiscal structure affect the amount of funds transferred to or away from that state, the practical working out of the transfer system would make necessary some determination of a standard state fiscal structure as the basis for calculation.[25] It is also noted that the

[23] A special form of this limiting case is that in which neither state levies taxes or provides public services.

[24] These effects can easily be seen by imposing changed conditions in the original model. Assume now that State A, instead of levying proportional tax rates, adopts a progressive income tax which increases the tax burden on its high income citizens, A-1 and A-2, to $1,050 each, and reduces the tax burden on A-3 to zero. Assume that the distribution of benefits in both states and B's tax rates remain the same as before. The fiscal positions then are as follows:

Name	*Total Taxes*	*Total Benefits*	*Fiscal Residuum*
A-1	$2,050	$1,225	$ 825
A-2	2,050	1,225	825
A-3	50	1,225	—1,175
B-1	2,000	925	1,075
B-2	150	925	— 775
B-3	150	925	— 775

In this model, a transfer of $166.67 among the three high income individuals, and $266.67 among the low income individuals is required, or a total of $433.34, as compared to the total of $400 before the change in A's tax structure was made.

[25] Applied to the existing structure in the United States this would not present serious difficulties since various state fiscal structures are substantially similar both on the tax and the expenditure side.

transfers are among equals; bloc transfers among states will satisfy the equity criterion only if made in a specific fashion. These and many other more technical problems make a precise application of the equity principle in the real world extremely difficult, but should not serve to prevent its use as a proximate standard for intergovernmental fiscal policy.

A specific type or method of intergovernmental fiscal adjustment is suggested from the above analysis. This is geographically discriminatory central government personal income taxation. Central government income tax rates could be made to vary from state to state so as to offset differences in state fiscal capacities.[26] This method of adjustment, by varying personal income tax rates among equals, could come closest to achieving the equity goal. In effect, it would limit the transfers to those among "equals." In the first model above, central government taxes on A-1 and A-2 would be increased from $1,000 to $1,100, while those on B-1 would be reduced from $1,000 to $800. Central government income taxes on A-3 would be increased from $50 to $250, while those on B-2 and B-3 would be reduced from $50 to a negative tax of $50.

Adjustment through the central governmental personal income tax system has another major advantage in that it allows the necessary inter-area transfer of funds to take place without any necessary increase in the total amount of federal revenue. This is an important feature in this era of big central government. Any other transfer method, either in the form of grants to states or geographically discriminatory central government expenditure, requires, initially at least, that a greater share of economic resources be diverted to flow through the central government fiscal mechanism. A further advantage of this adjustment system is that it does not conflict with either the revered principle of financial responsibility or that of state fiscal independence, both of which are so often encountered in discussions of grant-in-aid policy.[27]

Geographically discriminatory personal income taxation by the central government probably would, however, have to hurdle a very significant constitutional barrier before coming into existence in the United States. The courts have held repeatedly that the constitutional uniformity of taxation required was geographical in nature.[28] Although

[26] Adarkar included both geographically discriminatory central government taxation and geographically discriminatory central government expenditure as appropriate adjusting devices. (*Op. cit.*, p. 195.)

[27] See the following section.

[28] See *Head Money Cases* 112 US 580; *Knowlton* v. *Moore* 178 US 41; *Flint* v. *Stone Tracy Co.* 220 US 107.

accomplishing the same purpose as a system of positive revenue transfers, this method would appear more violative of traditional, though erroneous, equity precepts.[29] A more practical objection to this method is that individuals probably respond more quickly to tax burden differentials (especially direct taxes) than to differentials in public service standards. Therefore, if income tax rates vary from state to state in some direct correlation with per capita incomes, even though the system of rates were calculated so as to provide exact equality (to equals) in all states in over-all fiscal treatment, there might still be distortionary resource allocative effects due to this "tax illusion."

Any method of adjustment which involves the federal collection of revenue and subsequent transfer to state governmental units via specific or bloc grants is inferior to the tax adjustment method in so far as the equity criterion alone is considered. A system of grants based upon the equity principle could do little more than utilize the Canadian proposals. States could be placed in a position to treat citizens in the same manner fiscalwise as their equals in all other states. But states would not necessarily, or probably, choose to do so. Differences in the allocation of both burdens and benefits would be present. Nevertheless, the resultant inequities in the treatment of "equals" would be due to state political decisions, not to the fact that citizens were resident of the state *per se*. The differences in the treatment of equals could be reduced to insignificance in comparison to those now present.

V

The mere acceptance of the equity principle in discussions concerning the fiscal problem of federalism can yield important results. First of all, upon its acceptance inter-area transfers do not represent outright subsidization of the poorer areas, do not represent charitable contributions from the rich to the poor, and are not analogous to the concept of ability to pay in the inter-personal sense. The principle establishes a firm basis for the claim that the citizens of the low income states within a national economy possess the "right" that their states receive sums sufficient to enable these citizens to be placed in positions of fiscal equality with their equals in other states. A transfer viewed in this light is in no sense a gift or subsidy from the citizens of the more favored regions. It is no more a gift than that made from the

[29] The apparent anomaly here can be attributed in large part to the doctrinal errors made in economic and fiscal theory which have caused the expenditure side to be treated as a less important area of study than the tax side. Differing rates of federal taxation in different states would probably be declared unconstitutional. Arbitrarily differing amounts of federal expenditures per capita among states are not questioned.

citizens of the community property states to those of the non-community property states when income splitting for tax purposes was extended over the whole nation to make the federal tax system more equitable. After the proposed inter-area transfer of funds, relatively greater fiscal pressure would be imposed upon citizens of the high income areas and relatively less upon those of the low income areas in comparison to those now imposed. But tradition gives little ground for continuing inequities, and we normally give short shrift to the individual who has continued to escape a share of his fiscal burden.

The policy implications of adopting the equity principle as a long-run goal for adjustment policy are far reaching. Applied to the existing structure of intergovernmental fiscal relations in the United States, several steps are indicated. *First,* the elimination of the many matching provisions in the present grant-in-aid program is essential before progress can be made in any equalization policy. These provisions have served to prevent the whole grant-in-aid system from accomplishing any fiscal equalization between the rich and poor areas at all.

A *second* and major implication is that the equity approach provides a justification for inter-area transfers independent of any particular public service or group of services. In the past, the principle of fiscal need has been combined with the principle of national interest with the result that grants have been justified only in specific service areas (highways, vocational education, etc.). There is, of course, legitimate justification for federal grants to states with the objective of furthering certain national interests, for example, minimum standards in educational services. But such grant-in-aid programs should be sharply divorced from the basic equalization policy. It seems highly probable that, if an equalization policy of the sort proposed here were carried out, national interests would be adequately served without any national government direction of state expenditure. The low income states provide deficient educational standards largely because of their fiscal plight; remove this, and it seems likely that their service standards would approach those of other states without any restraints upon state budgetary freedom. The acceptance of the equity objective, therefore, could lend support to a policy of broadening the functions for which grants are made, and of extending broadened conditional grants to other public service areas.

Ultimately, an essential step, if equalization is to be carried out *via* grants to states, and one which will not be easy to accomplish, is the elimination of directional conditions entirely in federal grants to states and the substitution of unconditional grants. The equity principle provides an adequate justification for grants wholly unconditional, but traditional barriers against the unconditional intergovernmental transfer of funds, especially in the United States, are likely to loom large. The principle of financial responsibility which says, in effect, that "legislatures can be trusted to spend if required to tax accordingly,"[30] and not otherwise, is strong and has certain intrinsic merit when considered in isolation. But as is the case with the traditional principle of equity, the substitution of a federal political structure for a unitary one transforms the setting within which the principle may be applied. The fact that the central government must enter the adjustment process and transfer funds to effectuate equity in the over-all fiscal system does not therefore imply that the central government should be allowed to direct the recipient states in the allocation of their expenditure. There seems no apparent reason why there should be more central interference or direction in the financial operation of the recipient states than in that of the non-recipient states. States are made claimant through no fault of their own or of their respective citizens. They are made claimant by the income distribution arising from a resource allocation and payment in a national economy. Once it is recognized that the transfers are adjustments which are necessary to coordinate the federal political structure with a national economy, and as such are ethically due the citizens of the low income state units, then the freedom of these citizens to choose the pattern of their states' expenditure follows.

This concept of financial responsibility is, however, so strong that progress will perhaps require some compromise with it. Substantial progress can be made in intergovernmental transfer policy by the gradual substitution of procedural for directional conditions. Movement in this direction can be made while observing the fiscal responsibility principle and still not greatly reducing the budgetary independence of the states.

However, as pointed out above, these problems which arise in any intergovernmental policy utilizing revenue transfers, disappear when the method of geographically discriminatory personal income taxation is adopted. No governmental unit receives revenue other than what is internally raised within its fiscal system; therefore, neither the principle of financial responsibility nor that of state fiscal independence is violated. This method of adjustment, however, can only be expected to become positive policy after there is a more widespread recognition of the basic elements of the fiscal problem of federalism, and the advantages of this method over others clearly impressed upon the public by competent authorities.

[30] Henry C. Simons, "Hansen on Fiscal Policy," *Jour. Pol. Econ.*, Vol. L (1942), p. 178.

VI

The fiscal problem of federalism discussed here is not likely to become less acute. As the need for an ever-expanding scope of public services increases, with especial emphasis on the social services, the divergencies in fiscal capacities among state units will be more evidenced. The *laissez faire* result will be the ultimate centralization of a large share of effective political power, either directly through the assumption by the central government of traditional state and local functions, or indirectly through restraining financial conditions in an expanded grant-in-aid system. Therefore, those who desire to see maintained a truly decentralized political structure in the power sense, must take some action in support of proposals aimed at adjusting these interstate fiscal differences. Heretofore, little progress has been made, although increasing attention has been given to the problem. The failure to take positive steps may, in part, have been due to the lack of a specific long-run objective for policy. The equity principle presented here possibly offers an objective which, if accepted, can serve as the basis for the development of a rational intergovernmental fiscal adjustment system.