

COMMENT

A CRITIQUE OF SOME FEDERAL, STATE, AND LOCAL TAX COORDINATION TECHNIQUES

BURTON W. KANTER*

The attempts¹ at intergovernmental fiscal coordination during the past two decades² have been patternless³ and constitute an ineffectual organization of combatants for stability.⁴ Coordination cannot be looked upon as an abstract principle, for there is no virtue in coordination *per se*.⁵ It may be considered only as a problem-solving course of action.⁶ The

*Member of Illinois Bar; Teaching Associate, Indiana University School of Law.

1. If thoughts and words were but deeds, much good work would have been wrought long ago in the area of intergovernmental tax coordination. The problem has been the subject of innumerable discussions and studies by and on behalf of such groups as the Conference of Governors, the United States Treasury Department, the Council of State Governments, the Tax Foundation, the National Association of Tax Administrators, the American Bar Association, the American Legislator's Association, and the United States Congress.

The major comprehensive studies of the problem of tax coordination have been: *CONFLICTING TAXATION* (Progress Report of the Interstate Commission on Conflicting Taxation, sponsored by the Council of State Governments and the American Legislators' Association, 1935); Secretary of the Treasury, *Report of the Committee on Intergovernmental Fiscal Relations*, SEN. DOC. No. 69, 78th Cong., 1st Sess. (1943); *THE COORDINATION OF FEDERAL, STATE, AND LOCAL TAXATION* (the report of the Joint Committee of the American Bar Association, The National Association of Tax Administrators, and the National Tax Association, 1947); *Federal-State Relations* (report of the Hoover Commission—the Commission on Organization of the Executive Branch of the Government—prepared by the Council of State Governments), SEN. DOC. No. 81, 81st Cong., 1st Sess. (1949); and U. S. Treasury Department, *Federal-State-Local Tax Coordination* (Committee Print), 82d Cong., 2d Sess. (1952).

2. A detailed review of the record may be found in U. S. Treasury Department, *Federal-State-Local Tax Coordination* (Committee Print), 82d Cong., 2d Sess. (1952); Secretary of the Treasury, *Report of the Committee on Intergovernmental Fiscal Relations*, SEN. DOC. No. 69, 78th Cong., 1st Sess. (1943). See also Ecker-Racz, *Intergovernmental Tax Coordination: Record and Prospect*, 5 NAT. TAX J. 245 (1952); Stout, *Progress in the Coordination of State-Local Tax Systems—Some Principles and Methods*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 324 (1952) (discussing the extent of state, local tax coordination).

3. Conlon, *Coordination of Federal, State, and Local Taxation*, 266 ANNALS 144 (Nov., 1949); Shere, *An Economist's Viewpoint on Tax Policy*, 266 ANNALS 166 (Nov., 1949).

4. Shere, *supra* note 3. See also Hall, *The Coordination and Integration of Federal, State, and Local Tax Systems*, 10 WASH. L. REV. 22, 40 (1935).

5. Brown, *The Majority Viewpoint in the Committee on Coordination*, PROCEEDINGS, NATIONAL TAX ASSOCIATION, 316 (1947); Heer, *Coordination of American Federal, State, and Local Finance*, TAXATION AND PUBLIC POLICY (1936); cf. Doughton, *The Congressional Viewpoint on Conflicting Taxation*, 13 TAX MAG. (TAXES) 319 (1935).

6. See Newcomer, *Federal Aspects of a Coordinated Tax Program*, PROCEEDINGS,

ideas advanced as methods of coordination must be examined critically as solutions to intergovernmental fiscal problems and must be measured analytically by predetermined fiscal, economic, and political values.

I

Interest in coordination has vacillated over the years, becoming keenest whenever the financial problems of state and local governments loomed greatest.⁷ Presently, the fiscal situation for all levels of government is one of vastly increased expenditure programs and revenue needs.⁸ Moreover, it is no longer conceivable that the absolute size of government can be reduced.⁹ Continuing political tension between the East and the West indicates that the high level of defense expenditures by the federal govern-

NATIONAL TAX ASSOCIATION 200, 207 (1950), to the effect that the problem is more one of heavy, rather than duplicate, overlapping taxation.

7. Interest in the subject has been particularly intensified during time of war or depression; see note 73 *infra*. Ecker-Racz, *supra* note 2; Groves, *Intergovernmental Fiscal Relations*, TAXATION OF BUSINESS ENTERPRISE 131 (Summer Institute, Univ. of Mich. School of Law, 1951); Newcomer, *Fiscal Relations of Federal, State, and Local Governments in the United States*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 198, 200 (1940). For a discussion of the problems of state and local finance in wartime, consult TAX INSTITUTE, WARTIME PROBLEMS OF STATE AND LOCAL FINANCE (Symposium, 1942). The present proportion of defense spending which is tantamount to a wartime budget has vitalized the subject of tax coordination. Groves, *supra*.

8. Dominating the fiscal relations of all levels of government is a probable 1953 federal budget of \$75-85 billion. Approximately 84 percent of this amount will finance the national defense and international security programs and interest on the national debt.

Federal expenditures have risen from \$4,269,000 in the years 1789-91 to \$40,057,000,000 in 1948 to about \$66,000,000,000 in 1952. The peak of federal expenditures, \$100,397,000,000, was reached in 1945 (during the war). Total taxes collected by the federal government have risen from \$4,418,000 in the years 1789-91 to \$38,246,000,000 in 1949 to \$45,132,000,000 in 1951; Leland, *Financing the Relief-Recovery Program*, 9 Soc. SERV. REV. 414, 415 (1935); *Annual Report of the Secretary of the Treasury on the State of the Finances* (1953).

State expenditures in 1945 were \$4,500,000,000 and in 1951 had increased to \$13,000,000,000. In 1890, state revenues were \$107,000,000, and local revenues \$455,000,000. These have increased respectively to \$7,246,000,000 and \$8,295,000,000 in 1946. U. S. BUREAU OF THE CENSUS, HISTORICAL REVIEW OF STATE AND LOCAL GOVERNMENT FINANCES 13 (1948); U. S. BUREAU OF THE CENSUS, SUMMARY OF STATE GOVERNMENT FINANCES IN 1947 5 (1948).

9. Some persons have viewed reduction in governmental expenditures as the only proper means of coordinating federal, state, and local taxes. However, it is now manifest that "[g]overnment cannot be shrunk to the size of any favored past period." Shere, *supra* note 3, at 167.

While the absolute size of government cannot be expected to shrink, its size relative to the national economy must shrink if a free enterprise economy and a democratic government are to be maintained. The size of government relative to the national economy can be reduced despite increasing public expenditures if economic policies are directed to realize yearly the potential growth of national income at a rate which outstrips the growth of government. *Ibid*.

ment will persist. The cessation of hostilities in Korea has affected the level of domestic economic activity, making the intergovernmental fiscal situation more intense as the large revenue yields, resulting from high levels of economic activity, decline to a point short of the continuing expenditure obligations of both federal and state governments.¹⁰

Increased expenditure responsibility and revenue needs of local governments¹¹ have been satisfied largely in recent years by the states' granting new taxing powers¹² to their subdivisions and by these, in turn, levying, for the first time, a wide variety of nonproperty taxes.¹³ This increase in the kinds of taxes imposed by the local governments has extended sharply the overlapping of tax sources utilized¹⁴ by all levels of government.¹⁵ The inequitable tax distribution and the burdensome cost

10. For a thorough analysis of the state and local fiscal situation, consult Ecker-Racz, *supra* note 2, at 248-250.

11. To a great degree, these increased revenue needs are the result of substantial overlapping in the functions which local governments have undertaken to perform. This is also true of the state and federal governments.

12. See Newcomer, *The Decline of the General Property Tax*, 6 NAT. TAX J. 38 (1953), discussing the historical decline of the property tax as a satisfactory source for local revenue needs.

13. See Ecker-Racz, *supra* note 2, at 249; WHERE CITIES GET THEIR MONEY, 1951 Supp. (Municipal Finance Officers' Ass'n 1952); LOCAL UNITS GRANTED BROAD TAXING POWER (Penn. Dept. of Int. Affairs, Sept. 1948); *What American Cities Are Doing*, 50 PUB. MANAGEMENT 17 (1950); Gregg, *Toledo Adopts Payroll-Income Tax in Desperation*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 343 (1946); Studenski, *Post-War Financing of Municipalities and New Sources of Revenue*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 6 (1946); Stout and Myers, *The Development of Permissive Local Taxation Since 1945*, 13 CURRENT ECON. COMMENT 21 (1951). For a discussion of the import of this development on the attainment of "free, responsible" local government, see Grodzins, *State-Municipal Fiscal Relations: A Critical Commentary*, 3 NAT. TAX J. 1 (1950).

14. Overlapping use of tax sources is to be distinguished from overlapping taxation which is the result of jurisdictional conflicts concerning the subject matter of the tax, e.g., the subjection of an individual's intangible personalty to the property taxes of two different jurisdictions on the basis of either domicile or situs or domicile and situs. The imposition of a tax on the same property by two different (generally coordinate) jurisdictions does not constitute a determinative utilization by two or more jurisdictions (levels of government) of the same tax source (form of taxation).

For a discussion of other intergovernmental tax problems and instances of conflicting taxation, consult Conlon, *supra* note 3, at 146-48; Lynch, *Federal-State Fiscal Problems*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 364 (1949); Browne, *Federal-State Tax Coordination*, 31 CORNELL L. Q. 182 (1945).

15. Competition for sources of revenue is an incipient characteristic of all forms of government except the simplest unitary governmental entity consisting of no political subdivisions. Cf. Newcomer, *supra* note 6, at 200; Buehler, *Federal Grant-In-Aid Versus Separate Revenue Sources*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 384 (1949); Groves, *Intergovernmental Fiscal Relations*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 105, 107 (1942). Overlapping use of tax sources occurs in the United States because the states and the federal government alike can pass tax legislation without regard for the revenue plans of the other jurisdictions which have authority to impose taxes.

In the early years of the Union, the federal government was able to satisfy its revenue needs and expenditure functions through customs duties on imports, a tax source

of duplicate administration and taxpayer compliance,¹⁶ which are the consequences of this overlapping use of revenue sources, have focused attention on the need for coordination.¹⁷

constitutionally allocated to the federal government. U. S. CONST. ART. I, § 8. Subsequently additional revenue was raised from excises and sales of public lands. Conlon, *supra* note 3, at 145. On the other hand, state and local governments supported their expenditure programs from direct taxes, *i.e.*, the property tax and license tax. *Ibid.* By the first World War, this simple division of tax power had already begun to break down since the Sixteenth Amendment had empowered the federal government to tax incomes. The war sparked an ever increasing growth in the size and cost of government, a growth which continued through the depression and World War II. The increase in governmental activities necessitated expansion of taxing powers and search for additional revenue sources. The failure of the property tax as an efficient and sufficient source of state and local revenue tended to actualize the development and use of other forms of taxation, *i.e.*, the sales tax (general and special), the manufacturer's excise tax, and other special forms of excise. Newcomer, *supra* note 12. These events constitute the elemental causes of the present portraiture of federal, state, and local incoordination. Cf. SELIGMAN, *ESSAYS IN TAXATION* 673-676 (10th ed. 1925), for a further description of the development of federal, state, and local revenue systems. See also Newcomer, *supra* note 6, at 201; Buehler, *supra*, at 385-386; Haig, *The Coordination of the Federal and State Tax Systems*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 220 (1932).

Overlapping has occurred in three deep layers. For example, citizens of Wisconsin and New York pay income taxes only to federal and state governments, but residents of St. Louis pay income taxes to the city in addition to the federal and state governments. Residents of a suburb of Philadelphia who work in Philadelphia pay taxes to the city on income earned within the city while paying income taxes to the federal government on the total income. Illinois taxpayers in sixty districts contribute support to the federal and state governments and also one or more of nine local units, *e.g.*, county, city, township, common or grade school district, high school (or nonhigh school) district, park district, sanitary district, forest preserve district, and mosquito abatement or public health district. LELAND, *STATE-LOCAL FISCAL RELATIONS IN ILLINOIS* 31 (1941). Consult Conlon, *supra* note 3, at 145, for additional figures regarding the extent of overlapping taxation.

16. The burden is two-fold, but the ultimate cost is borne wholly by the taxpayer. The cost of government is increased by the dual (or multiple) administration of a particular form of taxation utilized by more than one level of government. In addition, the taxpayer incurs "directly" the cost of compliance which necessitates, for example, preparing the return, conferring and negotiating with the revenue agents, formulating protests, and litigating tax matters with the officials of each of two or more tax jurisdictions. There are no satisfactory statistics on the cost of taxpayer compliance, but it is evident the cost is substantial; of course, taxpayer "irritation" and "inconvenience" cannot be quantified in terms of money. Groves, *supra* note 7, at 132; Conlon, *supra* note 3, at 145. Cf. Long, *Report of Committee of National Tax Association on Coordination of Federal, State, and Local Taxes*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 658, 659 (1941).

17. Recently, two important groups have been authorized to develop a constructive program to resolve the problems of intergovernmental tax coordination. One study is to be undertaken by the "Temporary Commission on Fiscal Affairs of State Government," appointed by Governor Thomas E. Dewey of New York, under the chairmanship of Frederick L. Bird; Director of Municipal Research, Dun & Bradstreet, Inc. The other study is that of the "Commission on Intergovernmental Relations," appointed by President Eisenhower. The latter commission is charged primarily with making a broad study of all aspects of the proper role of the federal government in relation to the states and their political subdivisions and to make findings and recommendations to the President and Congress. It has been specifically authorized to consider the objectives of federal programs shared in by the states and the extent to which federal activities have advanced into fields which are the primary interest and obligation of the states. The

While taxes have traditionally been imposed to produce revenue, they have in recent years become economic, political, and fiscal weapons,¹⁸ capable of being used to secure a healthy, growing economy, composed of free, responsible units of government. Accordingly, the tax burden must be distributed in consonance with democratic notions of equity; at the same time taxes must not interfere with economic incentives to work and invest. The tax system must be so balanced as to minimize its repressive effects on consumption and production; it must be organized to sustain a high level of investment through savings and a high level of aggregate demand to insure that the economy may continue to grow with full employment and full production.

The tax system must be sensitive to cyclical fluctuations; fiscal policy must be directed at stabilizing the economy. Revenues must be greater than expenditures in periods of rising and high business activity and less than expenditures in periods of declining or low business activity.¹⁹

The preservation of democratic government depends on an over-all tax system which does not destroy free, responsible state and local governments.²⁰ Their fiscal independence and variable patterns of need and desire must be maintained²¹ while assuring society the common benefits to be derived from a certain national minimum of governmental service.²²

mandate to study the allocation of governmental functions and powers among federal, state, and local governments implicitly directs the commission to consider the problem of federal, state, and local tax coordination, the central issue of intergovernmental fiscal relations. But see notes 6 and 9 *supra*.

18. See BLOUGH, *THE FEDERAL TAXING PROCESS* 212-227, 233-237 (1952) (consult Chapter 10 for a description of the development of federal budget policies).

19. Simons, *Federal Tax Reform*, 3 *INT'L POSTWAR PROBLEMS* 19, 21 (1946); read BLOUGH, *op. cit. supra* note 18, at Chapter 11, for a critical analysis of alternative federal budget policies.

20. SIMONS, *ECONOMIC POLICY FOR A FREE SOCIETY* 13 (1948); MILL, *ON LIBERTY* 168-169 (Everyman's Library ed. 1910). See also, Grodzins, *supra* note 13; Shere, *supra* note 3, at 166, 167; *cf.* Groves, *supra* note 7.

It has been noted that the American value of "virile local government" has received the support of advocates of two distinct political ideas. On one hand, there are the "states-righters" who seem to believe that the least government is the best government, while, on the other hand, are those who are not necessarily interested in minimizing government but fear the tendency towards centralization, believing this to be the crux of the democratic value issue in local government. Groves, *The American Approach to Intergovernmental Fiscal Coordination*, *PROCEEDINGS, NATIONAL TAX ASSOCIATION* 318, 319 (1952). Compare the latter view with Simons' and Mill's belief in "free responsible" state and local government as a democratic value. See Weintraub, *American Federalism and Social Change*, 2 *J. LEG. & POL. SOC.* 153 (1943), suggesting that "federalism" is not a real issue for America. However, Weintraub distinguishes decentralization and federalism. American federalism is, presently, decentralized unitarism. *Cf.* POUND, McILWAIN, AND NICHOLS, *FEDERALISM AS A DEMOCRATIC PROCESS* (1942).

21. Progress in intergovernmental fiscal relations can be made without the federalization that threatens local fiscal independence; in fact, such progress may be the very nemesis of centralization. See Groves, *supra* note 15, at 108.

22. Clearly, federal taxation may influence state action on matters not directly related to taxation. Thus, taxes are an instrument the federal government can use to pro-

II

Deductibility.

The coordination device of deductibility is generally considered one of the greatest advances in federal, state fiscal relations. It consists of one jurisdiction permitting the deduction of taxes levied by another jurisdiction.²³ Presently, the federal government allows most state taxes to be deducted from the federal income tax base before determining tax liability.²⁴ Some states permit a similar deduction of specific federal taxes.²⁵

Deductibility tends to alleviate the effect of overlapping taxes²⁶ while retaining the states' sovereign power to impose and administer their own taxes. It also serves to prevent a confiscatory combined federal and state marginal tax rate for any individual, even though the nominal rates together exceed one hundred percent.²⁷ Furthermore, deductibility mitigates interstate tax competition.²⁸

State taxes which are deducted in arriving at net income subject to federal taxation are deducted against progressive rates. The result is

mote a national policy without assuming an additional governmental function. See BLOUGH, *op. cit. supra* note 18, at 441-442. See p. 40 *infra*. Consult generally Heer, *Taxation As An Instrument of Social Control*, 42 AMER. J. OF SOC. 484 (1937).

23. Double deductibility is achieved by each jurisdiction permitting the deduction of taxes collected by the other jurisdiction. With respect to the debate about "one-way" or "two-way," unilateral or double deductibility, consult Klarman, *Income Tax Deductibility*, 1 NAT. TAX J. 241 (1948); Johnson, *Income Tax Deductibility: A Reply*, 2 NAT. TAX J. 88 (1949); Klarman, *Income Tax Deductibility: A Rejoinder*, 2 NAT. TAX J. 89 (1949).

24. The deduction is not allowed with respect to inheritance, estate, or gift taxes, or taxes assessed against local benefits of a kind tending to increase the value of the property assessed. For a detailed description of the extent of deductibility for various taxes, consult U. S. Treasury Department, *supra* note 2; Conlon, *supra* note 3, at 146.

25. About two-thirds of the states which impose income taxes allow taxes paid to the federal government to be deducted in computing state tax liability. For a list of these states see U. S. Treasury Department, *supra* note 2, at 21 (Table 6).

It should be noted that the deduction is intended for the benefit of taxpayers rather than states. However, there is some indirect benefit realized by the state. See note 29 and text accompanying note 32 *infra*.

26. It reduces the total burden of two taxes.

27. Even with deductibility it is possible to have confiscatory taxation in the case of income irregular over several years or in years when tax rates are changed. Deductibility of state taxes from federal income tax liability is on a cash basis. Therefore, in the case of a very high income in one year followed by a very low income in the succeeding year, the state taxes on the high income, if "paid" in the year of low income, will be deductible against the low income to be subjected to tax; and the high state taxes paid, plus the federal tax due in the second year, might well be greater than the total income for the second year. To avoid this difficulty, it has been proposed that deductibility be put on an accrual basis. Groves, *supra* note 15, at 112. This suggestion, however, poses many difficult administrative problems. See Secretary of Treasury, *supra* note 1. Consult generally Gray, *Synchronizing Deductible Taxes and Taxable Income*, 9 U. OF CH. L. REV. 442 (1942).

28. It mitigates the differential of the total income tax burden as between states imposing income taxes, and between income tax and nonincome tax states. Groves, *supra* note 7, at 133.

discrimination in the effective rate of the state tax.²⁹ The impact of the graduation on the deduction is to reduce the combined federal and state tax burden more in the middle and higher income groups than in the lower income groups. To the extent that a large percentage of the lower income groups take the optional standard deduction,³⁰ this regressivity is further aggravated since the benefits of deductibility in reducing the effective tax burden are thereby limited to the middle and higher income groups where deductions are more normally itemized. The tendency (inherent in this technique) towards uniformity of tax burden may be in opposition to the basic notions of progression and equality underlying the federal income tax. However, while it is clear that the style of the progression is affected, it is probable that on the whole the entire federal, state, and local tax system remains progressive.³¹

Deductibility creates a revenue subsidy to the states at the expense of the federal government.³² The state tax rates are nominal and do not correspond in the least with the individual's effective tax liability. The states may therefore increase their revenues at less than dollar for dollar cost to the taxpayer by increasing a deductible tax. This would not seem to comport with fiscal responsibility since herein lies the ability to impose a rate of tax which fails to reflect revenue needs.

Variety among state tax rates is moderated when deductibility occurs at progressive rates of tax.³³ Therefore, the migration influence³⁴ of differing state rates is mitigated. Since the deduction reduces an individual's effective tax liability³⁵ and diverts much of the impact of the tax from the taxpayer to the federal government, the states may increase deductible taxes without imposing an equivalent net burden on the taxpayer and, thus, with less fear of driving out the wealthier taxpayers.

29. As a result of the deduction, the net burden of the state tax is no greater than would result from a lower tax rate in absence of the deduction. From this point of view, the deduction indirectly benefits the state. See note 25 *supra* and text accompanying note 32 *infra*.

30. The value of deductibility has been effectually eliminated for most individual taxpayers by the "standard deduction" (except to the extent that the specific deductions, for which the standard deduction may be substituted, amount to more than the standard deduction) since the optional deduction is allowed whether or not any deductible taxes have been paid.

31. It should be recognized that a state tax imposed on the benefit principle cannot really be considered to have been so imposed when the effective burden of the tax is determined by deductibility under progressive rates.

32. Klarman, *supra* note 23; Shoup, *Influence of Coordination on Federal Policies, TAX RELATIONS AMONG GOVERNMENTAL UNITS* 8, 9 (1937).

33. *Ibid.*

34. Typically, migration is said to occur in the case of wealthy individual taxpayers moving from states having high inheritance or income taxes to no-tax or low-tax states and in the case of entrepreneurs establishing themselves in lower- or no-business tax states.

35. This is necessarily so since the net addition of the tax is less as the deduction occurs higher up the progressive rate scale.

However, it would seem that if consideration were given to the innumerable factors other than tax liability which determine where a business shall operate or a person shall live, and to the existence generally of relatively low state tax rates,³⁶ the entire migration argument might be subjected to review.³⁷ Moreover, if migration were a serious problem and there were no deductibility from the federal tax, it is conceivable that the states might develop uniform and lower rates.

Sharing.

Another technique frequently proposed for intergovernmental fiscal coordination is tax sharing.³⁸ The federal government would levy and administer the taxes and then return all, or part, of the proceeds from certain taxes to the other levels of government.³⁹ This would eliminate duplicate administration and compliance. It would also eliminate interstate tax competition by effecting uniformity in rates.⁴⁰

The case for tax sharing rests on the arguments for centralized collection.⁴¹ It is at least doubtful whether the lower levels of govern-

36. At present, the highest rate is only 20 percent. State income taxes have remained at relatively low rates for competitive and other reasons and thus do not seriously rival the federal levy. Groves, *supra* note 7, at 135.

37. This is not to say that if there is migration, it is of no importance. Quite to the contrary, to the extent that there is migration, there may be a serious economic impact on the efficient allocation of resources.

38. *E. g.*, SELIGMAN, *op. cit. supra* note 15, at 386, 389.

A variant of the tax sharing technique, adopted in Canada, is a scheme of "tax rental." Smith, *The Federal Viewpoint on the Canadian Approach to Coordination of Tax Systems*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 292 (1952). See also Gathercole, *A Provincial Viewpoint on the Canadian Approach to Tax Coordination*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 299, 301 (1952). Consult Eaton, *Canadian Experience in Coordinating Federal and Provincial Taxing Power*, TAXATION OF BUSINESS ENTERPRISE 141 (Summer Institute, Univ. of Mich. School of Law, 1951), for a descriptive history of the events leading up to the adoption of the present "tax rental" agreements. The provinces have temporarily relinquished to the Canadian federal government their right to levy certain taxes in return for compensation in the form of annual money payments. In essence, the rental payment is tied to a rise in national production and income and a growth in provincial population. See Gathercole, *supra*. The Canadian scheme of coordination does not appear to be easily distinguishable in any significant respects from the general idea of tax sharing. Perhaps the most difficult problem Canada had to solve was a practical way of computing the rental payment while taking into account both the taxable capacity and fiscal need of the province. *Ibid.* See Heller, *Recent Canadian and Australian Experience in Intergovernmental Fiscal Relation*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 297 (1946), concerning the lessons to be gleaned from the Canadian experience.

39. The federal, state, or local governments could be assigned those taxes which each respectively is most capable of administering. In all probability this would necessitate almost full withdrawal of local governments from the tax field.

40. The system would be virtually impossible to administer unless this were so.

41. This is also the most significant basis for criticizing tax sharing as a coordinating technique. Sharing, more than any other technique (grants-in-aid being next) tends to produce extreme centralization.

ment can capably administer the more desirable forms of taxation, e.g., the income tax (progressive or nonprogressive). Furthermore, the proposed "collection agency" relationship between the federal government and the other levels of government can be justified by an apparently greater ability of local governments to perform service functions than to collect revenues.⁴²

Under a sharing system, it is necessary to determine a rational basis upon which to allocate taxes. Formulae which return the revenue either on the basis of origin or in accordance with need are most logical. Proposals for returning revenue collected on the basis of origin is often justified on the ground that the locale from which the tax is taken is entitled to the "fruits of its labor." But under modern economic conditions, in a complex interdependent society, "income" is difficult to localize, and it is not easily seen what is the fruit of what labor.⁴³ Tax sharing on the basis of origin tends to let unneeded revenue flow to certain areas⁴⁴ while others receive insufficient tax proceeds.⁴⁵ Even if the proceeds returned were subject to a specific maximum limitation, there would tend to be an unevenness in the spread of tax revenue. Clearly, then, local patterns of need and fiscal capacity would not be reflected. However, if the origin principle were manifestly appropriate, its application would still be difficult and complex since the meaning of *origin* is not apparent. The many *situs* and *domicile* problems concerning jurisdiction to tax which still plague tax experts would also require solution.

If revenue is returned on the basis of need, tax sharing operates as a method of equalization, subsidizing the poorer districts at the expense of richer ones. Whereas this would reflect fiscal capacity, the technique does not manifest local choice in imposing the tax. There may even be some tendency for the subsidy to perpetuate inefficient districts and unjustifiable expenses.⁴⁶ However, a degree of subsidization may be war-

42. It is sometimes argued that income and wealth, the ultimate sources of all taxes, are "nationally" created and cannot be properly localized for decentralized taxation.

43. See Weintraub, *supra* note 20; see also note 42 *supra*.

44. Groves, *supra* note 7, at 135. It is likely that these areas would not themselves have raised the excess revenue.

45. *Ibid.*

46. The principle has been characterized in the following manner: When money moves from the locality to the state or federal government and back again, the local citizens lose their proprietary interest in the revenue and forget that it is their own money they are spending. See Groves, *supra* note 7, at 136. Colin Clark, a noted Australian economist, drawing from the experience of his country with shared taxes (see Heller, *supra* note 38) has stated the rule as follows: "Public money is never spent with real care and responsibility unless those politically responsible in spending it know they will also have to raise it (or at any rate the greater part of it) from their own electors." CLARK, PRINCIPLES OF PUBLIC FINANCE AND TAXATION 9 (1950). The circuitous routing of local finances compromises the local sense of independence and induces local governments to depend on the central units.

ranted to the extent that there is a large measure of common benefit to be derived from a certain minimum pattern of expenditure.⁴⁷

Separation of Sources.

Separation of revenue sources (forms of taxation) has long been advocated as a method of tax coordination⁴⁸ though it does not constitute coordination or integration in any real sense.⁴⁹ Generally, separation plans involve a reallocation of tax sources to one or another level of government on the basis of either (or both) the peculiar adaptability of the form of taxation to use by that level of government or (and) the greater capability of that level of government to administer the particular form of taxation.⁵⁰ Source separation would permit each district independence in choosing to impose a particular tax (among the allocated tax bases) as long as no duplication occurred with other levels of government. Thus, there could be no overlapping of revenue sources. In addition, the separation of tax sources tends to reduce the costs of tax administration and the burdens of tax compliance.⁵¹

Federal sharing in Germany apparently induced some state and local extravagance during prosperity and effected a maldistribution of funds during depression. See Groves, *supra* note 15, at 113.

47. For a further evaluation of sharing as a coordinating technique, consult Newcomer, *Revenue Sharing Between Federal and State Governments and Between State and Local Governments*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 275 (1936).

48. E.g., Kaiser, *An Integrated and Coordinated Tax Program*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 683 (1941) (Federal government: import tariffs, excise taxes on tobacco and alcoholic beverages, inheritance taxes, social security taxes, retail sales and manufacturers excise taxes, income taxes, oil and mineral taxes. State governments: motor fuel, oil, and vehicle taxes, occupational license taxes, capital or franchise taxes. Local governments: property taxes.); Browne, *Let's Coordinate Our Tax Systems*, 23 TAXES 825 (1945) (Federal government: income taxes. State government: gasoline, motor use and vehicle taxes, admissions and entertainment taxes.); LUTZ, *BRING GOVERNMENT BACK HOME!* (rev. ed. 1950); Rossman, *Discussion of Report of National Tax Association Committee on Intergovernmental Fiscal Relation*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 239 (1943).

Presently, there exists some separation in fact, e.g., customs duties may still be imposed only by the national government. Some states have abandoned the property tax to local subdivisions, and it is not permitted to the federal government as a direct tax. Various excise taxes are not utilized extensively by the several levels of government. The sales tax is not utilized by the federal government. Nevertheless, it is clear that joint or common use of the available tax sources is more frequent than infrequent. For a detailed discussion of other legal limits on the taxing powers of each level of government and the consequent "partial separation of sources of revenue," consult Hall, *supra* note 4, at 25-29. Cf., Driscoll, *Coordinating Federal, State, and Local Taxes*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 192 (1950).

49. Hall, *supra* note 4, at 36.

50. Some would make the division coincide with financial needs.

51. To the extent that delimiting the use of a particular form of taxation to one level of government eliminates double performance by tax administrators and taxpayers of the same duties, it is true that the cost of government administration and taxpayer compliance is reduced. However, to the extent that a jurisdiction imposes a *new* tax to offset the loss in revenue occasioned by "separation," the costs of both government ad-

Source separation suggestions are usually conjoined with calls for reallocation of certain governmental functions.⁵² It is assumed that each level of government will thereafter be able to support its expenditures by means of its own tax levies.⁵³ Since the uneven fiscal capacity (geographically) of various districts would not be affected by a reallocation of tax sources, it is improbable that source separation will permit state and local governments to meet their revenue needs.⁵⁴ This would lead to a multiplication of the forms of taxation as revenue needs increase. The result would be a regressive system of taxation and an inequitable tax distribution.⁵⁵

The general problem of tax incidence has been wholly ignored by the advocates of separation schemes. Ultimately, the source of tax payments must be mainly income and, to a lesser degree, wealth, irrespective of the form of taxation by which the tax is exacted. That an incoordinated tax system provides a less satisfactory basis than a coordinated and integrated tax system for determining and apportioning the ultimate tax burden is manifest, but proposals for source separation do not and cannot separate the incidence of taxation.⁵⁶

ministration and taxpayer compliance may be increased rather than decreased. See BLOUGH, *op. cit. supra* note 18, at 452.

52. It is possible that a level of government which is peculiarly capable of either (or both) using or (and) administering a particular form of taxation would not be equally capable of effectively performing a given governmental service.

53. It is also assumed that governmental functions can be separated to a great extent.

54. Haig, *Federal Tax Collection with Allocation of Share Proceeds to the States*, 11 TAX MAG. (Taxes) 96 (1933).

For a thoughtful analysis of the policy considerations involved in "separation of sources" as a coordination technique for state and local finances, see Newcomer, *Separation of State and Local Revenues in the United States*, COLUMBIA UNIVERSITY STUDIES IN HISTORY, ECONOMICS AND PUBLIC LAW (1917); FINAL REPORT OF CALIFORNIA TAX COMMISSION 44 et seq. (1929); Newcomer, *Tendencies in State and Local Finance and their Relation to State and Local Functions*, 43 POL. SCI. Q. 1 (1928).

55. The legal and practical difficulties preventing source separation are virtually insurmountable. Source separation would require that both the states and the federal government withdraw certain forms of taxes which each presently imposes. To make the withdrawal universal and binding might require a constitutional amendment. At the least, voluntary action on the part of the states would be necessary; this would be politically difficult to secure and would require uniform action of a great number of governmental units. See BLOUGH, *op. cit. supra* note 18, at 454. It has, however, been urged that the federal government begin the accomplishment of source separation by unilaterally withdrawing from the use of some specific tax sources. *E.g.*, PROCEEDINGS OF THE GOVERNORS' CONFERENCE, Resolution III, App. IV, 192 (1952); Groves, *supra* note 15, at 111 (withdrawal of federal government from the motor vehicle tax field, leaving motor vehicle fuel taxes to the states and aviation fuel taxes to the federal government).

56. Consult Buehler, *supra* note 15, at 388-391, for a further evaluation of the separation of tax sources as a coordinating technique. See also Adams, *Separation of the Sources of State and Local Revenue as a Program of Tax Reform*, PROCEEDINGS, NATIONAL TAX ASSOCIATION (STATE AND LOCAL TAXATION) 515 (1907). In addition consult authorities cited in note 54 *supra*.

Tax Credits.

The tax credit is already a familiar coordination device in the areas of estate⁵⁷ and payroll tax.⁵⁸ The credit is not a deduction of the tax paid in one jurisdiction from income to be taxed in another jurisdiction; rather it is an offset of one (or part of one) tax dollar against another. In a sense the tax of one jurisdiction is paid with the tax receipt of the other jurisdiction.

The tax credit serves to bring about a considerable degree of uniformity in the state tax rates and thereby to eliminate interstate tax competition.⁵⁹ This technique controls, to a large degree, the pattern of state revenue measures, standardizing the forms of taxation. Further, tax crediting leads to compulsion and rigidities in that the states feel obligated to adopt the particular tax subject to the credit arrangement and to adjust the rates of tax to take full advantage of the credit.⁶⁰ The state rates tend towards the maximum allowable credit under the prevailing federal rate.⁶¹ Over-all, the state tax situation would seem to move towards uniformity, at higher rates than would have otherwise been imposed. The independence of the states to determine rates for themselves is more apparent than real, for the federal government, in effect, determines the total rate since the amount the states may collect without further burdening the individual taxpayer is practically restricted to the credit which is allowed. It is apparent also that under a scheme of credits the fiscal needs of the states are satisfied out of the federal revenues.⁶² However, inequalities in fiscal capacities are not affected.

Tax credit arrangements fail to attain efficiency and economy in tax administration and compliance. Duplicate administration in general is retained.⁶³

57. An 80 percent credit for death taxes paid to a state is allowed against the federal tax imposed by the Revenue Act of 1926. INT. REV. CODE § 813(b).

58. A credit of 2.7 percent is allowed to the states against the 3 percent unemployment (social security) tax imposed by the federal government. INT. REV. CODE § 1607(a).

59. In addition to preventing the continued existence of a few tax havens, the federal estate tax credit constitutes a virtual relinquishment of the death tax field to the states. Conlon, *supra* note 3, at 146.

60. See Hall, *supra* note 4, at 36; Magill, *The Coordination of State and Federal Taxes*, 15 TAX MAG. (TAXES) 187, 189 (1937).

61. It should be noted with respect to the federal estate tax credit that the credit is inapplicable to increases in estate tax rates over the tax imposed by the Revenue Act of 1926. See note 57 *supra*. This has resulted in a substantial shift in the distribution of total death taxes between the federal government and the states as compared with the earlier distribution. See Conlon, *supra* note 3, at 146.

62. Morrissett, *The Effect of the Federal Estate Tax Credit on State Finances*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 739 (1938) (the federal estate tax credit substantially increased state revenues from death taxes).

63. However, it is clear that the crediting provision for taxes paid to another state prevents taxation of the same income by more than one state.

Grants-in-aid.

The grant-in-aid is a coordination method presently in wide use.⁶⁴ It is much like tax sharing, but in contrast grants are usually made for specific purposes. However, the state and local governments cannot claim a grant-in-aid as a matter of right and must often comply with certain conditions. Moreover, sharing is generally tied to a specific tax source whereas grants come out of general revenues.

The grant arrangements have for the most part grown out of the failure of state and local governments to meet their fiscal responsibilities. They are also used to accomplish particular social objectives on a nationwide basis. Grants (particularly when they are made on a matching basis) tend to distort particular patterns of locally determined expenditures since there is great stimulation to take advantage of the grant. It is, therefore, a powerful economic weapon for establishing a uniform minimum standard for certain socially desirable expenditure programs. Yet it is clear that this compulsion inherent in the use of the grant-in-aid must in some degree destroy the fiscal independence of the state and local governments.⁶⁵ Wealthy districts may not have wished to expend revenue for the particular objective the grant is designed to enhance despite their fiscal capacity to do so. Moreover, the grant formulae are not always satisfactory, in that they may fail to take account of the varying fiscal capacities of certain areas. Poor districts may be coerced to spend their revenue on the objective the grant is designed to enhance while sacrificing some other locally desirable objective. Nevertheless, the grant arrangements do serve as equalization factors to the extent that they are based on indexes of need.⁶⁶

It may be suggested that grant arrangements can be effectively used to stabilize cyclical trends, since the extent of grant aid could be varied during times of prosperity and depression, according to sound federal fiscal policy. However, it must be recognized that it is extremely difficult to withdraw grant arrangements once begun.⁶⁷

64. See SEN. DOC. NO. 81, 81st Cong., 1st Sess. (1949), for the scope of federal and state grant-in-aid programs.

65. On the other hand, it is clear that grants without standards might be another wasteful expenditure which did not accomplish the disbursing government's objective.

66. And, to that extent, the federal government is effectually financing services of national concern. For a discussion of the problems to be faced in achieving equalization under grants-in-aid, consult Blough, *Federal and State Grants-in-Aid*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 266 (1936).

67. For a further evaluation of the grant-in-aid as a coordination technique, consult Buehler, *supra* note 15, at 391-395; Newcomer, *Revenue Sharing Between Federal and State Governments*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 275 (1936).

Supplements.

Tax supplements have too long been disregarded as a technique offering the possibility of a high degree of coordination.⁶⁸ A tax supplement consists of the states (or lower levels of government) levying their tax in terms of a percentage of the federal tax.⁶⁹ Under this arrangement, all levels of government use the same tax base. The arrangement may be utilized while either retaining independent administration by various levels of government or permitting all tax administration to devolve upon one centralized authority.

Taken alone, supplements suffer the disadvantage that revenues will fluctuate widely with changes in tax policies of the federal government which imposes the basic tax. However, plans have been suggested which tend to correct this defect.⁷⁰ State and local governments would build reserves during periods of high economic activity.⁷¹ These reserves would then be used to meet expenditure responsibilities during periods of low economic activity. There would, therefore, be no need for the state and local governments to impose greater and new taxes during depressions to meet their expenditure programs.⁷² This arrangement would accord with sound federal fiscal policy.⁷³

Supplements, while retaining the use of an overlapping revenue source, do not involve the same inequitable regressive tax distribution presently in existence since there would be fewer forms of taxation and

68. See Groves, *New Sources of Light on Intergovernmental Fiscal Relations*, 5 NAT. TAX J. 234 (1952), discussing the Scandinavian experience with supplements as a method of coordinating intergovernmental tax conflicts. See also Hall, *supra* note 4, at 36.

69. The supplement can also be levied in terms of percentage points added to the applicable federal rate.

70. Shere, *supra* note 3, at 170; Shere, *A Tax Program for Puerto Rico*, 6 NAT. TAX J. (1953); Shere, *Tax Reserves for State and Local Governments*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 187 (1945). See also Shere, *American Tax Problems in 1949*, 27 TAXES 369, 377 (1949).

71. This may be impossible to accomplish if pressures for increased expenditures and lower taxes during times of high business activity are too great. This is probably the basis of the statement that "[f]or political reasons, it is difficult for these governments [state and local] to accumulate and retain surpluses at any time." BLOUGH, *op. cit. supra* note 18, at 453.

72. The states and local governments would resort to borrowing only after the reserves are exhausted.

73. In fact, if federal countercyclical arrangements are to be effective, the states must be prevented from too greatly increasing any supplemental taxes. In the past the fiscal policies of state and local governments has generally run counter to the program for stability pursued by the federal government. This perversity has led to deficits when there should have been surpluses and surpluses when there should have been deficits. It is recognized, broadly speaking, that incurring deficits during depression and accumulating surpluses during prosperity is an element of sound governmental fiscal policy. However, state and local governments cannot follow this course of action, for during depression they lack monetary and borrowing powers, and during prosperity they are subject to the pressures which prevent retention of surpluses. See note 71 *supra*.

these would generally be progressive. Under supplemental arrangements, state and local governments assume fiscal responsibility for levying the tax though they are compelled to utilize a particular form of taxation. Variable patterns of local need and desire can be reflected in this levy. However, supplemental arrangements do not provide a minimum standard of governmental service among the states and cannot correct for the different fiscal capacities of the various states⁷⁴ by spreading the tax burden in proportion to wealth.

There are some administration problems which arise from the use of the same tax base. Either the central administration must face all the difficulties of interpreting the tax law or there must be duplication of effort in this respect. A central authority would have to control disputes over the source of a tax, solving the perplexities of allocating business income and the various *situs* and *domicile* problems of individuals. Nonetheless, it is certain that local governments are better able to handle the task of administering supplements than a wide variety of other forms of taxation. However, if there were unitary administration, taxpayers would pay a single composite tax, and taxpayer and government administrator alike would be relieved of many compliance difficulties and irritations.

Uniformity.

Substantial adoption of uniform tax bases and methods of computation in the income tax field⁷⁵ has engendered advocacy of this technique as a method for coordinating other forms of taxation utilized by two or more levels of government. However, "uniformity" serves only to reduce the taxpayers' cost of compliance and to simplify tax administration (consequently providing a basis for administrative cooperation)⁷⁶ and cannot alleviate the other consequences of overlapping use of revenue sources. Moreover, the formula of "uniformity" is only as sound as the quality of the form of taxation selected. The problems of administering and interpreting the tax laws tend to undermine the object of uniformity

74. It has been suggested that supplemental grants will nevertheless be unneeded. Shere, *Tax Reserves for State and Local Governments*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 187 (1945). *Contra* Domar, *Discussion of Shere Paper*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 200 (1945).

75. See U. S. Treasury Department, *supra* note 2, at 23.

76. It is interesting to note the existence of two concurrent polar pressures: On one hand, uniformity tends to achieve cooperative administration while, on the other hand, it has been suggested that the current development of closer administrative relationships among the field staffs of the state and federal governments as well as among the several states might generate from within the administrative structure pressures for the elimination of existing differences and building of uniformity. Conlon, *supra* note 3, at 149.

unless solved by uniform (necessarily joint) administration, extending probably to the judicial level.

Administrative Cooperation.

Manifestly, administrative collaboration is an important aspect of any program for coordination; nevertheless it has been advanced as a unitary technique for coordinating intergovernmental taxation. As a coordination technique, administrative cooperation must be considered as either delegated or joint administration. Delegation involves a contractual arrangement under which duplicate administration is eliminated, and one level of government collects taxes for the other. Joint administration permits both levels of government to continue to administer their own taxes but in combined operation through exchange of personnel and other facilities. Administrative cooperation of either type⁷⁷ would tend to alleviate the cost of duplicate administration and compliance but could not serve to correct the other maleffects of overlapping taxation. The tendency to develop uniformity in the tax base is subject to the same criticism as "uniformity" in general.⁷⁸

Fiscal Commission.

The establishment of a fiscal commission has been urged frequently as an instrument of coordination.⁷⁹ The suggestions usually have involved the establishment of a permanent and continuous organization made up of representatives of the executive and legislative branches of the federal, state, and local governments. The commission would be charged with dealing practically with fundamental policy problems and administering the program of coordination.⁸⁰

In reality this approach cannot be classified as a theoretic technique for coordinating federal, state, and local taxation. A fiscal commission charged with resolving the problems of intergovernmental fiscal relations is in essence an instrument for effecting coordination. An agency serving this function has a place in any scheme of coordination. However, the mere establishment and subsequent action of a fiscal commission is not a practical solution to the problem of coordinating intergovernmental

77. Consult Conlon, *supra* note 3, for the kinds of activities that might be administered cooperatively.

78. For a further discussion of problems of federal-state coordination by administrative means, consult *Fourth Round Table Discussion*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 200 (1943).

79. *E.g.*, Groves, *supra* note 15, at 110-111. Chapman, *A Federal-State Fiscal Agency as an Instrument of Coordination*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 277 (1946).

80. *Cf.* Groves, *supra* note 15, at 111.

fiscal relations. A group of experts intending to solve fiscal problems in a practical way must base their actions upon a theoretically sound program capable of practical operation serving the needs and fiscal objectives of the community. The establishment of an intergovernmental fiscal agency neither insures action nor, in the case of action, appropriate action. The establishment of the agency may be useful at any point in the development or administration of a program for intergovernmental fiscal coordination. But the agency cannot be considered as an ultimate goal since its establishment acts only as a force aiding solution of the problem of tax coordination and is not a resolution of that problem.

A continuing commission concerning itself with tax coordination would have to study the allocation of functions and powers among the federal, state, and local governments with a view to developing an acceptable scheme of future allocation. The commission would have to study the fiscal relations of all levels of government for the purpose of achieving consistency in the fiscal policies to be followed by the several levels. The commission would also have to consider the extent to which available revenue sources should be exploited.

Conclusion

Clearly, no single method of tax coordination can compel the assent of all as a solution of the problem of conflicting taxation. However, it is necessary to have an over-all program designed to accomplish intergovernmental tax coordination⁸¹ before any single difficulty can be adequately solved.⁸² The economic implications and effects of the various devices which have been discussed must be fully recognized before a rational program of coordination can be developed.

81. A coordination program must meet the challenge of increasing the revenue of state and local governments, reducing the cost of duplicate administration and taxpayer compliance, promoting the utilization of the most desirable forms of taxation, producing a more equitable distribution of the tax burden, implementing a national minimum of service, facilitating the pursuit of a coordinated fiscal policy for stability, and preserving the fiscal independence of state and local governments.

82. "Not being daring or cynical enough" to say that "the American approach to intergovernmental fiscal coordination has been all approach and no arrival," Professor Groves has characterized the approach as pragmatic and eclectic. Groves, *The American Approach to Intergovernmental Fiscal Coordination*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 318 (1952). See also Groves, *Intergovernmental Fiscal Relations*, *supra* note 15, at 107: "[T]he preoccupation . . . with grandiose plans [are accountable in part] for the . . . low score of achievement. . ."; Lynch, *Federal-State Fiscal Problems*, PROCEEDINGS, NATIONAL TAX ASSOCIATION 364, 365 (1949). The Treasury Department considers the solution of intergovernmental fiscal problems as a "gradual process," resulting in gradual progress. U. S. Treasury Department, *supra* note 2, at 11; Secretary of the Treasury, *supra* note 1 (to the effect that a piecemeal attack on specific problems was necessary since a comprehensive readjustment of intergovernmental fiscal relations was impossible). See also Newcomer, *supra* note 6, at 201. *Contra* Hall, *supra* note 4; Haensel, *The Place of Illinois in A Rational Scheme of Tax Reform*, 35 ILL. L. REV. 622, 652 (1941).